

STATE BAR OF CALIFORNIA TAXATION SECTION INTERNATIONAL COMMITTEE<sup>1</sup>

## HOT TOPIC

**“OOPS - THE ACCIDENTAL INVERSION”  
THE SCOPE OF SECTION 7874 - TO CERTAIN IN-BOUND INTERNATIONAL TRANSACTIONS  
NOT INTENDED BY CONGRESS TO BE A “CORPORATE INVERSION”**

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**SUMMARY – SECTION 7874  
AND  
POLICY TO DISCOURAGE U.S. MULTI-NATIONALS FROM EXPATRIATING**

Congress spoke clearly when it adopted Section 7874 in the American Jobs Creation Act in 2004 (the “Act”) to discourage corporate inversions by U.S. based multinational corporations such as the one announced in 2002 by Stanley Works, a U.S. based manufacturer of tools. Stanley intended to follow other U.S. based corporations such as Ingersoll-Rand and Cooper Industries who reincorporated in jurisdictions outside of the United States.

Section 7874(b) effectively treats the “inverted” foreign corporation as if it were a domestic U.S. corporation for purposes of the entire Internal Revenue Code (Title 26). As this paper will discuss, Section 7874 was never intended to tax foreign based or foreign owned multinational corporations (or foreign owned – closely held corporations) as if they were U.S. corporations. This is, however, exactly the unintended consequence of Section 7874 since 7874(b) provides that “Notwithstanding Section 7701(a)(4), a foreign corporation shall be treated for purposes of this title as a domestic corporation . . .” The unintended tax implications are far reaching (including withholding tax, income tax, informational reporting requirements and estate and generation skipping transfer tax implications to the non-resident alien shareholders). This paper explains the issues associated with Section 7874(b) and its unintended application to certain foreign owned in-bound international transactions and investments. The author is not certain whether guidance from the Service or Treasury can adequately address these issues, or whether a technical legislative clarification will be required.

The Treasury Department summarized well the type of corporate inversion transactions Section 7874 is intended to discourage in its May 2002 study – *Corporate Inversion Transactions: Tax Policy Implications*:

Since the late 1990s, an increasing number of U.S.-based multinational corporations have engaged in so-called “corporate inversions” or “corporate reincorporations”. A corporate inversion is a transaction or series of transactions through which a U.S.-based multinational restructures its corporate group so that the ultimate parent corporation of the group becomes a foreign entity. If accompanied by the movement of the multinational’s ownership of its foreign operations to the foreign entity, the effect is the removal from the U.S. tax base of the income of the foreign operations that is or may be included in U.S. taxable income in the future. If accompanied by an increase in the leveraging of U.S. operations through intercompany debt or by a transfer of intangibles to the foreign entity, the effect is the reduction of the U.S. taxable income of U.S. operations . . . an inversion may be accomplished through one of several alternative transaction forms.<sup>3</sup>

<sup>1</sup> The comments contained in this paper are the individual views of the author (who is the Immediate Past Chair of the International Committee and current Executive Committee member of the State Bar of California, Taxation Section) who prepared them and do not represent the position of the State Bar of California.

<sup>2</sup> Although the participant on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

<sup>3</sup> See – *Corporate Inversion Transactions: Tax Policy Implications*, Office of Tax Policy, Department of Treasury (May 2002).

The “penalty” for a corporate inversion is to require the expatriated entity to have taxable income of no less than the inversion gain pursuant to Section 7874(a). The policy was designed to assure the inverted corporation (now a foreign corporation) should not be able to obtain any U.S. tax advantage compared to a similarly situated domestic corporation. Section 7874 was clearly designed to discourage U.S. based and U.S. owned operations from moving offshore and “expatriating” to obtain any U.S. tax advantage. The policy of the statute was not designed to discourage foreign owned operations from moving some or all of its operations (including through reorganizations) directly or indirectly to the foreign country of its owners; yet this seems to be the unintended consequence.

## I. Corporate Inversions –

### A. Policy to Discourage U.S. Based Groups from “Expatriating”

As the 2002 Treasury study explains: “The term “inversion” is used to describe a broad category of transactions through which the corporate structure of a group of corporations with a U.S. parent (a “U.S.-based group”) is altered so that after the transaction, the ultimate parent of the corporate group is a foreign corporation. Typically, that foreign parent corporation is incorporated in a jurisdiction that imposes little or no income tax. This basic reincorporation outside the United States often is accompanied by a series of other restructuring steps. Most commonly, the associated restructuring involves a shift outside the United States of the ownership of the group’s existing foreign operations, accomplished through the transfer of existing foreign subsidiaries to the new foreign parent corporation or a foreign subsidiary thereof.”<sup>4</sup>

Additionally, the Senate finance committee expressed its concerns for why corporate inversion legislation must be adopted – “The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations. The Committee believes that certain inversion transactions (involving 80 percent or more identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes. The Committee believes that other inversion transactions (involving more than 50 but less than 80 percent identity of stock ownership) may have sufficient non-tax effect and purpose to be respected, but warrant heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions.”<sup>5</sup>

### B. Domestic vs. Foreign Corporations – “Accidental Inversions”

The U.S. income tax law has broad application to domestic corporations. Section 7874(b) now extends these concepts to foreign owned foreign corporations which happen to inadvertently fall into the definition of an “expatriated entity” pursuant to Section 7874(a)(2)(A)(i). The following simple example of a U.S. corporation with a current or future foreign holding corporation (which in turn is owned exclusively directly or indirectly by non-resident alien investors) will help illustrate the unintended tax consequences of the new rules in Section 7874, specifically those arising out of the rule set forth in Section 7874(b).

**EXAMPLE 1 –Foreign Owned U.S. Corporation:** Foreign individual shareholders formed a domestic U.S. corporation (“US-CORP”) under the laws of Delaware to conduct a U.S. trade or business. US CORP is subject to U.S. income taxation on its worldwide income and has never owned U.S. real property interests and hence is not a United States Real Property Holding Corporation. US CORP limits its commercial activities to those which would otherwise constitute a U.S. trade or business. All shareholders of US-CORP are (i) non-resident alien (“NRA”) investors who reside in foreign country (“W”) and (ii) foreign corporations formed in Country W which are wholly owned by NRAs of Country W. For various foreign tax and legal and U.S. estate tax purposes, NRA investors decide to reorganize US-CORP so it will become a wholly owned subsidiary of a foreign corporation. Accordingly all shareholders of US-CORP (who are NRAs or foreign corporations formed in Country W) transfer all of their shares to a new foreign holding corporation (“F-CORP”) formed in Country W in exchange for shares of F-CORP.

US-CORP, of course as a U.S. domestic corporation continues to be subject to U.S. income taxation on its worldwide income. Without the application of Section 7874(b), F-CORP would be a foreign corporation under 7701(a)(4) and US-CORP would be a domestic corporation pursuant to Section 7701(a)(5). However, if F-CORP is a “surrogate foreign corporation” pursuant to Section 7874(b) whereby 80 percent of the shareholders of US-CORP are now (directly or indirectly) shareholders of F-CORP, then F-CORP will also be deemed a domestic corporation for all

<sup>4</sup> *Id.*

<sup>5</sup> See 107TH CONGRESS, Report, SENATE, 2d Session 107-188 REVERSING THE EXPATRIATION OF PROFITS OFFSHORE ACT (June 2002).

purposes of Title 26. In this example, F-CORP will indeed be a “surrogate foreign corporation” since 100 percent of the shareholders of US-CORP will be shareholders of F-CORP.

Accordingly, in this example, the first prong of Section 7874(a)(2)(B) will be satisfied since substantially all of the properties that were held directly or indirectly by US-CORP, a domestic corporation (or substantially all of the properties constituting a trade or business of US-CORP) will be acquired by F-CORP when the shares are exchanged.<sup>6</sup> Of course, all of the business and operating assets remain inside US-CORP and the business activities of US-CORP have not changed; only its shareholders have. The second prong of the statute will be satisfied since more than 60 percent of the shareholders remain the same. In this case 100 percent of the shareholders of US-CORP will become the same shareholders in F-CORP.<sup>7</sup> Finally, the third and last prong will be satisfied since F-CORP will be a holding corporation whereby its only asset is stock of US-CORP, and will carry on no substantial business activity in Country W.<sup>8</sup>

Hence, F-CORP will now be treated as a domestic corporation for all purposes of Title 26.

This is an extraordinary result, considering a NRA can sell or transfer stock of a U.S. corporation (e.g., US-CORP) free from taxation if the shares are not stock of a “United States Real Property Holding Corporation” (“USRPHC”) pursuant to Section 897.

These new rules will not modify the rules that a non-resident alien or foreign corporation can sell or transfer stock of a domestic corporation free from U.S. taxation.<sup>9</sup> However, the new rule in Section 7874(b) enables a non-resident alien or foreign corporation to transfer stock of a USRPHC tax-free, which was previously a taxable transfer. This can be demonstrated in the following Example 2:

**EXAMPLE 2 –Foreign Owned U.S. Corporation - USRPHC:** Assume the same facts as in Example 1, except that US-CORP’s trade or business is investing and managing real property located in the United States and that the majority of all US-CORP’s assets are United States Real Property Interests (“USRPIs”). Also, assume that F-CORP is formed in low tax jurisdiction country “X” instead of “W.”

In this Example 2, F-CORP will be treated as a domestic corporation. The significant difference, however, is that the stock transfer of US-CORP to F-CORP will not necessarily be taxable, even though it is a transfer of a USRPI by non-resident aliens and foreign corporate shareholders of US-CORP which would otherwise be taxable under FIRPTA. This example will be explained in more detail later. Additionally, the following examples will help explain additional tax issues associated with informational reporting requirements and withholding tax matters:

**EXAMPLE 3 –Foreign Owned U.S. Corporation –F-CORP Conducts Foreign Trade or Business Activity:** Foreign Corporation Begins Conducting Significant Foreign Trade or Business Operations. Assume the same facts as in Example 1, except that F-CORP now begins to conduct various foreign trade or business activities that generate income which is not effectively connected with a U.S. trade or business. Furthermore, assume F-CORP conducts substantial business activities in Country Z such that the business activities conducted by F-CORP are 100 times the size (in both revenue and capital investment) of the U.S. trade or business activities of US-CORP in the U.S. Country Z has an income tax treaty with the U.S.

**EXAMPLE 4 –Foreign Owned U.S. Corporation – Related Party Transactions:** Assume the same facts as in Example 1, except that US-CORP principally purchases inventory and product from a foreign affiliate of F-CORP which is manufactured in country X. US-CORP is the sales distributor of the product it purchases from the affiliate of F-CORP, which is also formed and operating in country X, which is a low-tax jurisdiction and does not have a tax treaty with the U.S.

**EXAMPLE 5 –Foreign Owned U.S. Corporation – USRPHC – US-CORP liquidates:** Assume the same facts as in Example 2, except that US-CORP is now dissolved and thereby makes a liquidating distribution of all of its assets (including all USRPIs) to F-CORP. When F-CORP sells the USRPIs it will be a domestic corporation and no withholding under Section 1445 will be required.

<sup>6</sup> See Section 7874(a)(2)(B)(i).

<sup>7</sup> See Section 7874(a)(2)(B)(ii).

<sup>8</sup> See Section 7874(a)(2)(B)(iii).

<sup>9</sup> See Sections 864(b) and 871(a)(2).

## II. Unintended Consequences

This is where the many unintended consequences and problems arise to F-CORP which only has NRA and foreign corporate shareholders and no U.S. shareholders. The result is an extraterritorial application of U.S. tax law, treating F-CORP which only has NRA shareholders – as a U.S. domestic corporation for all purposes of Title 26.

### A. Withholding Tax Complications – No Withholding Taxes

This new rule now means that distributions from domestic corporations to foreign corporations (where the foreign corporation is now treated as a domestic corporation pursuant to section 7874) are no longer subject to U.S. withholding taxes. Accordingly, the Service will have no power to collect, nor will any withholding tax arise from US-CORP when distributions of dividends or other fixed or determinable annual or periodical gains, profits or income are made by US-CORP to F-CORP.

U.S. payors and withholding agents must withhold 30 percent (or a lesser tax treaty rate) of “. . . fixed or determinable annual or periodical gains, profits, and income. . .” (“FDAP income”)<sup>10</sup> made to foreign corporations and non-resident alien individuals.<sup>11</sup>

This new rule of Section 7874(b) means that since F-CORP is now treated as a domestic corporation for all purposes of the Title 26, the only withholding tax will arise when F-CORP makes a distribution of FDAP income to its non-resident shareholders. In Examples 1 through 4 above, all FDAP payments made by US-CORP to F-CORP will now be treated as payments made between two U.S. corporations and not subject to withholding tax pursuant to Sections 1441 and 1442. The withholding tax will apply only when F-CORP makes dividend or other FDAP distributions to the foreign non-resident shareholders and foreign corporate shareholders of F-CORP.

This begs the question: How can the Service effectively collect U.S. withholding tax from any foreign corporation operating outside of the U.S. which makes dividend payments to its foreign shareholders? The collection of the U.S. tax on dividends and other FDAP will now be shifted from the domestic corporation (as the withholding agent) to the foreign corporation which may have no U.S. resident officers, directors or shareholders.

### B. Tax Return Filing Complications – filing obligations by foreign corporations (F-CORP)

Since F-CORP will be treated as a domestic corporation for purposes of Title 26, it will be subject to worldwide taxation in accordance with the rate schedule specified in Section 11(b), “. . . on the taxable income of every corporation.” It will also be subject to estimated tax payments and procedural requirements under Section 6655.

Additionally, F-CORP will be subject to U.S. corporate income tax on its foreign source in Example 3. Once F-CORP starts conducting trade or business activities (irrespective of the fact that all activities are conducted outside the U.S.) all of its foreign source income from Country Z which is not effectively connected to a U.S. trade or business will now be subject to U.S. corporate income taxation.

If F-CORP has no U.S. officers, U.S. shareholders, U.S. directors and keeps no books or records in the U.S., how does the Service enforce F-CORP’s U.S. income tax obligations which now arise from the application of Section 7874(b)?

### C. Informational Reporting Requirements Will Not Apply – Service’s Ability to Enforce Section 482 will be Impeded

Certain U.S. corporations with foreign owners are required to furnish information to the IRS under Section 6038A, and may be subject to a \$10,000 annual penalty for failure to file the informational report. U.S. corporations which have this reporting obligation are those which are (i) “25 percent foreign owned.”<sup>12</sup> Additional reporting requirements arises when the following elements are met: (1) there is a U.S. domestic “reporting corporation,”<sup>13</sup> and (2) the reporting corporation is engaged in certain “reportable transactions,”<sup>14</sup> (3) with a “related party.”<sup>15</sup>

The purpose of Section 6038A (and the requirement to furnish information thereunder) is to enable the IRS to obtain information to conduct transfer pricing studies under Section 482. As one court has stated, the purpose of Section

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<sup>10</sup> See I.R.C. Sections 871 and 881.

<sup>11</sup> See I.R.C. Sections 1441 and 1442.

<sup>12</sup> See Section. § 6038A.

<sup>13</sup> See Section. § 6038A(a).

<sup>14</sup> Treas. Reg. § 1.6038A-2(b)(3) and (4).

<sup>15</sup> See Section § 6038A(c)(2).

6038A is “to aid the IRS in enforcement of section 482; its sponsors in the House of Representatives described it as an effort to “[i]mprove [the] enforceability of section 482.”<sup>16</sup>

In Example 4, without application of Section 7874, US-CORP would be a reporting corporation since it would be deemed to be 25 percent foreign owned (i.e., 100 percent owned by F-CORP). Hence, US-CORP would have the informational reporting requirements to reflect its foreign ownership and the host of reportable transactions it has with foreign affiliated entities. Accordingly, US-CORP would typically reflect its various inventory and product purchases from its foreign affiliate on its U.S. informational reporting return (IRS Form 5472) to enable the IRS to enforce the proper application of Section 482.

Section 7874 now changes this result, since F-CORP will now be treated as a domestic corporation and hence US-CORP cannot be deemed to be “25 percent foreign owned.” Instead, the informational reporting requirements will shift from US-CORP to F-CORP, which will now be deemed the “reporting corporation” since F-CORP is now deemed a “domestic corporation” that is “25 percent foreign owned.”

Again, the question becomes, how can the Service enforce the informational reporting requirements against F-CORP with foreign shareholders. This is only exacerbated if all of F-CORP’s activities are conducted outside of the U.S. and it has no officers, directors or other company managers with connections to the U.S.

Clearly, this change brought on by Section 7874(b) will serve to frustrate the intended purpose of Section 6038A, since the Service will not have adequate information from the U.S. tax return of US-CORP regarding its foreign party related transactions and foreign ownership.

#### **D. Lack of Tax Treaty Conformity – Tax Treaty Override?**

If F-CORP is treated as a domestic corporation for all purposes, this determination will conflict with most U.S. income tax treaties and the definitions of when an entity is to be treated as a resident company.

For instance, Article 4 of the U.S.-Mexico Income Tax Treaty (which is a fairly standard treaty provision) provides in relevant part as follows:

##### ARTICLE 4 RESIDENCE

1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a [similar] nature. . . .

In all of the Examples 1 through 5, F-CORP has no “place of management” or “place of incorporation” in the United States and normally would not be deemed to be a resident of the U.S.

Furthermore, most treaties provide that the U.S. cannot impose taxation on non-U.S. source income from foreign resident corporations of the treaty country if they do not have a minimum commercial or management presence within the U.S. (e.g., a “permanent establishment” or a “fixed base” in the United States). This rule also applies to prevent the foreign treaty country (e.g., Country Z) from imposing taxation on the operations of most U.S. corporations without sources of income from Country Z, including US-CORP provided it has no place of management in Country Z). Specifically, Article 7 of the U.S.-Mexico tax treaty expressly provides as follows:

##### ARTICLE 7 - BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on or has carried on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on or has carried on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to

a) that permanent establishment; . . .

The unintended consequence of Section 7874, is that F-CORP in all of the above examples is now treated as a domestic corporation for purposes of Title 26 and hence is deemed to be a resident of the U.S. and subject to U.S. taxation on its worldwide income. F-CORP is treated as if it was “. . . created or organized in the United States or under the law of the United States.” This turns the rule of Section 7701(a)(4) on its head and if F-CORP has no U.S. source income, no “permanent establishment” or “fixed base” in the United States, it would generally not be subject to taxation in the U.S. by virtue of the terms of the treaty provisions for country W and Z.

<sup>16</sup> *ASAT, Inc. v. Comm’r*, 108 T.C. 147 (1997), citing, *H. Rept. 101-247*, at 1295 (1989).

Did Congress intend to override all U.S. income tax treaties that have these universal principals of taxation (by virtue of the “later in time” rule as applied with new Section 7874)?

The United States Supreme Court has interpreted the supremacy clause of the U.S. Constitution to provide that U.S. international income tax treaties have the same force as any federal legislation.<sup>17</sup> Accordingly, tax legislation that is subsequently passed (“later in time” than the adoption of an earlier tax treaty that is in conflict with the legislation) overrides the application of the tax treaty.<sup>18</sup>

This “later in time” rule articulated by the Supreme Court has led to much international criticism, since most countries do not allow their legislative (and/or executive) branch to unilaterally modify international treaties without the consent of the other contracting state.<sup>19</sup> Nonetheless, it appears that the new rules created by Section 7874(b) may have overridden the application of nearly all of the U.S. income tax treaties regarding corporate tax residency and permanent establishment rules in this international in-bound context.

#### **E. Avoidance of FIRPTA Rules Avoidance of FIRPTA Withholding Tax – Service’s Inability to Collect Tax Overseas**

Yet another unintended consequence of Section 7874, is to eradicate the application of and the taxation rules to US-CORP and F-CORP as set forth in the Foreign Investment in Real Property Tax Act (“FIRPTA”) which were codified in Sections 897 and 1445.

Since F-CORP will be treated as a domestic corporation for purposes of Title 26, Sections 897 and 1445 will no longer apply when it disposes of United States Real Property Interests (“USRPI”) as explained below.

A foreign corporation or a non-U.S. citizen (e.g., a Canadian citizen who resides in Canada or outside the U.S.) who does not have (1) U.S. source income or U.S. source income “effectively connected” with a trade or business, and (2) does not stay in the U.S. to satisfy the “183” day “substantial presence” test per year, does not generally have to pay income taxes to the U.S. government.

FIRPTA imposes taxation “as if” the foreign investor was engaged in a U.S. trade or business and “as if” such gain or loss is effectively connected to a U.S. trade or business.<sup>20</sup> FIRPTA also imposes a mandatory withholding mechanism by which part (all or more than all) of the tax must be withheld by the buyer (or third party withholding agent) immediately upon the sale or disposition of the U.S. real property interest **provided the seller is not a U.S. person.**<sup>21</sup>

Upon the sale or other disposition of a United States Real Property Interest (“USRPI”) by a foreign person, the transferee (e.g., the buyer) generally must withhold 10 percent of the total amount realized from the sale and not just from the taxable gain. A U.S. partnership, estate, or trust that disposes of a USRPI is generally subject to a 35 percent withholding tax to the extent such gain is allocable to a foreign partner or beneficial owner of the entity.<sup>22</sup> Foreign corporations must also withhold 35 percent of the gain recognized with respect to any distributions of a USRPI to the corporations’ shareholders.<sup>23</sup>

In Example 3, F-CORP will not be subject to the withholding tax under the FIRPTA rules, e.g., when it sells U.S. real estate, since it will be deemed to be a domestic corporation for all purposes of Title 26 (including Section 1446). In Example

<sup>17</sup> See, *U.S. Constitution, art. VI, § 2*; *Foster v. Neilson*, 27 US (2 Pet.) 253, 314 (1829), *Samann v. Comm’r*, 313 F2d 461, 463 (4th Cir. 1963) and *American Trust Co. v. Smyth*, 247 F2d 149, 153 (9th Cir. 1957).

<sup>18</sup> See *Cook v. United States*, “A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.” 288 US 102, 120 (1933); *Accord Menominee Tribe v. United States*, 391 US 404 (1968); *Lindsey v. Comm’r*, 98 TC 46 (1992) (reference to legislative history of the Technical and Miscellaneous Revenue Act of 1988, which expressly states that the later-in-time rule shall apply with respect to the limitation on the use of foreign tax credits against minimum tax liability, as modified in the Act); *Restatement (Third) Foreign Relations Law of the United States (1987), § 115(a)*; “Terr Discusses Tax Treaty Developments” (interview with L. Terr, International Tax Counsel), 1 Tax Notes 157, 158 (Jan. 9, 1989).

<sup>19</sup> See *Sachs*, “Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?” 47 Tax Law. 867, 881 (1994); and *OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides (1989)*, reprinted at 2 Tax Notes Int’l 25, 26 (1990). Furthermore, the *Supreme Court of Mexico’s Thesis by Justice Olga Sánchez Cordero*, established that even if the laws of the States conform to local State laws they must still conform to the laws established in article 133 of the Mexican Constitution. See, *Mexican Supreme Court Thesis 1a. XVI/2001*.

<sup>20</sup> See I.R.C. Section 897(a)(1).

<sup>21</sup> See I.R.C. Section 1445.

<sup>22</sup> *Treas. Reg. § 1.1445-5(c)(1)*.

<sup>23</sup> *Section 1445(e)(2)*.

Again, how can the Service collect the rightful U.S. income tax associated with the gain from sale of the U.S. real estate when F-CORP has the proceeds in a foreign country (free from FIRPTA withholding tax)? F-CORP might decide to distribute the proceeds from the sale of the U.S. real property, to its foreign shareholders, which would also be subject to withholding tax under Sections 1441 and 1442 (FDAP distribution from a deemed domestic corporation – F-CORP – to non-resident alien or foreign corporate shareholders).

The problem becomes a very significant enforcement problem for the Service, since it now must try to collect a U.S. income tax in a foreign country against a foreign corporation vis-à-vis its foreign shareholders. This is a very different scenario compared to the intended “corporate inversion” scenario where Congress and the Treasury Department focused upon U.S. managed and U.S. owned multi-nationals with both U.S. and foreign operations.

#### **F. Branch Profits Tax – How it Can Now Vanish!**

The branch profits tax imposed on foreign corporation with respect to its U.S. operations, is of course designed to mirror the taxation foreign investors would have from their U.S. business operations as if they invested through a U.S. corporation. To accomplish this, Section 884 imposes a 30 percent tax on the “dividend equivalent amount”<sup>24</sup> [which] means the foreign corporation's effectively connected earnings and profits for the taxable year adjusted as provided in this subsection . . .<sup>25</sup> This branch profits tax is sometimes modified by various tax treaties.<sup>26</sup>

The new rule under Section 7874, however, will mean that F-CORP will not be subject to the U.S. branch profits tax on its “. . . “dividend equivalent amount”.

The unintended result: foreign investors may now indeed prefer to operate and conduct U.S. operations through a foreign corporation in a low tax jurisdiction (e.g., British Virgin Islands). In the above Example 4, if F-CORP is formed and operates from the British Virgin Islands, it can conduct a U.S. trade or business free from any branch profits tax since it will be deemed a domestic corporation pursuant to new Section 7874. This is easily accomplished where the foreign investors first form a U.S. corporation to conduct its U.S. operations.

Again, this shifts the tax collection burden of U.S. taxes to the foreign corporation – F-CORP – upon distributions to its foreign shareholders. See above discussion II.A **Corporate Inversions –Withholding Tax Complications – No Withholding Taxes**. How can the Service assert jurisdiction over and effectively collect the withholding tax on dividends distributed from F-CORP to NRAs (both of whom reside and operate exclusively outside of the United States)?

#### **G. Change of U.S. Estate Tax Regime – Regarding Shares of Foreign Corporation**

The next unintended result is from the transfer tax regime. The United States estate tax has limited application to nonresident decedents who are not citizens of the United States. The tax generally only extends to assets defined as “situated in the United States” under Code Section 2104 at the time of death.<sup>27</sup> In 1954,<sup>28</sup> Congress clarified the situs treatment of stock of domestic corporations versus foreign corporations to provide a bright-line test for determining United States estate taxation for ownership interests in corporations.<sup>29</sup>

Stock of domestic corporations are deemed to be “situated in the United States” pursuant to Section 2104(a) and Treasury Regulation Section 20.2104-1(a)(1).<sup>30</sup>

Section 7874 will now modify this rule under Section 2104 (presumably unintentionally) for stock in foreign corporations which are deemed to be domestic corporations under Section 7874(b) for all purposes of Title 26. In all examples 1 through 4, all foreign non-resident alien shareholders of F-CORP will now be deemed to own property subject to U.S. estate tax upon their death. This is true, even if the sole asset of F-CORP is stock of US-CORP.

One of the additional unintended consequences of Section 7874(b) is that now all foreign executors and administrators of estates, certain persons in possession of estate property, and transferees, can be personally liable for the United States estate tax arising from the shares of F-CORP when it comes due.<sup>31</sup>

<sup>24</sup> Section 884(a) and (b).

<sup>25</sup> Section 884(b).

<sup>26</sup> Section 884(e) and See – Article 11A of the U.S.-Mexico Income Tax Treaty which reduces the branch profits tax.

<sup>27</sup> See I.R.C. § 2101(a).

<sup>28</sup> S. REP. 83-1622 (1954).

<sup>29</sup> H.R. REP. 83-1337 (1954), reflecting the change in the law whereby “. . . stock held by nonresident aliens is treated as property situated in the United States if it is stock of a domestic corporation regardless of where the certificates are located . . . .” Prior to this change in the law stock of a foreign corporation was also deemed property situated in the United States if the certificates were physically located in the United States.

<sup>30</sup> See supra, footnote 29, explaining bright-line test adopted in statute for stock of domestic and foreign corporations.

### III. CONCLUSION

The general effect of Section 7874(b) to foreign investors, is to shift the U.S. tax burden (including withholding tax obligations and informational reporting requirements) from the U.S. corporate operations (e.g., the U.S. subsidiary) to the foreign corporate shareholder. Additionally, in those circumstances where the foreign corporation is treated as a domestic corporation by application of Section 7874(b), the tax collection burden of the Service now shifts from the U.S. to the foreign jurisdiction. The problem becomes a very significant enforcement problem for the Service, since it now must try to collect U.S. withholding and U.S. corporate income taxes in a foreign country against a foreign corporation vis-à-vis its foreign officers and directors.

The Service will undoubtedly be frustrated in its efforts to enforce the U.S. tax law vis-à-vis the foreign parent corporations in foreign jurisdictions (especially in those countries without any U.S. income tax treaty) when there is no nexus to the U.S. other than the U.S. shareholdings of foreign parent corporation.

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<sup>31</sup> See I.R.C. § 6324(a).