Chapter 10

FEDERAL TAXATION OF INTERNATIONAL TRANSACTIONS

Daniel Cassidy

10.1 INTRODUCTION

Foreign companies with U.S. business transactions face various layers of taxation. These include income, sales, and excise taxes levied by all levels of government—federal, state and local. The purpose of this chapter is to provide an overview of U.S. federal income taxation as it applies to a foreign company’s investment and business transactions. We will not cover non-income taxes or taxes levied by state and local governments. Some of these issues are covered in other chapters of this book.

For purposes of this discussion, we will assume that we are dealing with a corporation that is formed outside of the United States and is involved in business or investment activity in the United States. The rules for foreign individuals, estates, trusts, and non-corporate entities are similar to those discussed in this chapter. However, in the interest of keeping the discussion to a manageable size, we will not address these issues.

10.2 KEY CONCEPTS AND DEFINITIONS

How business and investment income is taxed in the United States depends on who is earning the income, the nature of the income, and whether the transaction giving rise to the income is covered by a bilateral income tax treaty. This section will outline the general scheme of taxation in the United States as it relates to foreign corporations and will give an overview of certain definitions and key concepts. Later sections will explore specific types of transactions in greater detail.

10.2.1 General Scheme of Taxation

The overall scheme of taxation of international transactions in the United States can be broken down into two categories: the taxation of U.S. persons and non-U.S. persons. In the context of corporate taxation, this distinction can be stated as the taxation of domestic corporations and foreign corporations.

1 Daniel Cassidy is a Certified Public Accountant and a Principal with Clark Nuber P.S. in Bellevue, Washington.
Domestic corporations are subject to U.S. taxation on their worldwide income—income from all sources, regardless of whether earned from activities in the United States or abroad. This income is subject to taxation on a net basis (gross income less expenses) at graduated corporate tax rates. Domestic corporations are also subject to a comprehensive anti-deferral regime that is designed to prevent taxpayers from sheltering income in offshore entities. Foreign corporations are not subject to this anti-deferral regime; however, U.S. subsidiaries of foreign corporations are subject to such provisions.

Foreign corporations are subject to U.S. taxation on two broad classes of income: investment income from U.S. sources and income that is effectively connected to a U.S. trade or business. Investment income consists of interest, dividends, rents and royalties, and similar types of income from passive investments. This income is taxed on a gross basis at a flat rate of tax and is subject to source withholding. It also includes gains from the sale of assets that give rise to investment income. These gains are subject to U.S. tax to the extent that they are derived from U.S. sources.

A foreign corporation’s business income is subject to tax in the United States to the extent that it is considered to be effectively connected to a U.S. trade or business. Income that is effectively connected to a U.S. trade or business is subject to net taxation at graduated tax rates—similar to U.S. corporations.

Before we delve deeper into the details of U.S. taxation of international transactions, it is important to become familiar with important key concepts. These key concepts include the following:

1. Corporate residency: Domestic and foreign corporations;
2. Source of income: U.S. source income and foreign source income;
3. Type of income: Investment income and business income; and

### 10.2.2 Corporate Residency

A corporation’s residency can be broken down into two classes—domestic and foreign. A domestic corporation is any corporation that is created or organized under federal or state laws in the United States. A foreign corporation is any corporation that is not a domestic corporation.

U.S. tax law determines residency of a corporation based on the jurisdiction of formation, but certain other countries determine residency based on where the corporation is managed or controlled. As a result, a corporation could be considered resident in two countries—raising the possibility of double taxation. Many income tax treaties resolve this problem. However, for transactions not covered by treaty, this situation can cause significant double taxation issues.
10.2.3 Source of Income

U.S. tax law classifies all income into one of two categories—U.S. source and foreign source income. In general, a foreign company’s U.S. source income is subject to U.S. tax, while its foreign source income is exempt. The source of an item depends on the type of income. The following is a summary of how common types of income are classified. It should be noted that exceptions apply to these rules.

1. **Interest and dividend income** – Interest and dividend income are sourced based on the residence of the obligor. Interest or dividends paid by a domestic company are U.S. source income; interest and dividends paid by a foreign company are foreign source income.

2. **Royalty income from the use of intangible property** – Royalty income from the use of intangible property is sourced to the country where the intangible asset is located or used.

3. **Rental income** – Rental income associated with real or personal property is sourced to the country where the property is located.

4. **Income from the provision of services** – Income from the provision of services is sourced to the location where the services are provided.

5. **Income from the sale of wholesale goods** – Income from the sale of goods that are not manufactured by the seller are sourced to the location where the risks and benefits of ownership are transferred from the seller to the buyer.

6. **Income from the sale of manufactured goods** – Income from the sale of goods manufactured or produced by the seller are sourced fifty percent to the location where the goods are manufactured or produced and fifty percent to the location where the risks and benefits of ownership are transferred from the seller to the buyer.

7. **Gains from the sale of corporate stocks and bonds** – Gains from the sale of stocks and bonds are sourced to the residency of the seller.

8. **Gains from the sale of real property** – Gains from the sale of real property are sourced to the location of the property.

10.2.4 Types of Income

A foreign company’s U.S. taxable income is broken into two types: investment income and income that is effectively connected with a trade or business in the United States (hereafter, “effectively connected income”). Investment income consists of interest, dividends, certain rents and royalties, and similar types of income from passive investments and is referred to as FDAP (FDAP is an acronym for “fixed or determinable annual or periodical gains, profits, and income.” The acronym FDAP will be used hereafter.) It also includes gains from the sale of assets that give rise to FDAP income or that give rise to no income.
A foreign corporation’s FDAP income is taxed in the U.S. to the extent it is derived from U.S. sources as determined under the source rules described above. Such income is taxed on a gross basis (no deductions or expenses are allowed) at a fixed tax rate. The statutory tax rate is 30 percent, but is often reduced under the provisions of applicable income tax treaties.

Effectively connected income consists of business income related to U.S. activities. In order to have effectively connected income, a foreign company must first have a U.S. trade or business. Once it is established that a foreign company has a U.S. trade or business, its effectively connected income will consist of all U.S. source business income and certain foreign source income that is associated with the U.S. trade or business.

A foreign corporation’s effectively connected income is taxed in a manner similar to a U.S. corporation. The tax is levied on net taxable income, which consists of gross income less allowable business deductions. The net taxable income is subject to graduated tax rates ranging from 15 to 35 percent.

10.2.5 Bilateral Income Tax Treaties

Bilateral income tax treaties play an important role in the taxation of international transactions. They are designed to reduce the possibility of double taxation and allocate the right to tax international transactions between governments. Absent these treaties, the domestic laws of different countries could, and often would, lay claim to tax the same income. Tax treaties resolve this conflict, and in doing so, can override a country’s domestic law. Therefore, in order to understand U.S. taxation of international transactions we must look not only to U.S. law, but to the contents of its income tax treaties.

Income tax treaties address a broad range of issues and each treaty has unique provisions. It is beyond the scope of this chapter to cover all of these issues. The discussion below is a summary of common treaty provisions affecting business investment in the United States.

1. Residency Tie-breaker Rules – The United States considers any corporation formed under its laws to be a U.S. resident. Many other countries determine residency based on where the corporation is managed and controlled; this leads to the possibility of a corporation being treated as resident in more than one country. Income tax treaties often resolve this conflict by specifying a set of tie-breaker rules used to determine residency.

2. Reduction of Withholding Tax on FDAP Income – FDAP income is subject to a withholding tax at the rate of 30 percent. Income tax treaties commonly reduce withholding rates on interest, dividends and royalties. Treaty rates typically range from zero to 15 percent.

3. Business Profits – Under domestic tax law, the United States will tax all business profits that are effectively connected to a U.S. trade or business. This includes profits earned by a foreign company that has no U.S. office. Under most income tax treaties, foreign companies will not be subject to U.S. tax on business profits unless they have a permanent establishment in the United States. A permanent establishment generally
results from an office or fixed place of business located in the United States or the existence of employees or dependent agents that habitually exercise the authority in the United States to conclude contracts on behalf of the company.

4. **Limitation of Benefits** – Most U.S. income tax treaties contain comprehensive limitation of benefits provisions. These provisions are designed to prevent third country entities, conduits, and holding companies from being used to obtain advantageous treaty benefits for individuals and companies which would otherwise not be eligible.

5. **Information Exchange** – In addition to the reduction of double taxation and the allocation of tax revenue, an important function of income tax treaties is to improve enforcement of income tax laws on international transactions. To this end, most income tax treaties contain information sharing provisions that allow the party nations to exchange tax information and coordinate enforcement activities.

### 10.3 TAXATION OF FOREIGN COMPANIES

In this section we will consider the taxation of a foreign company’s investment and business income in the United States. The goal will be to examine common types of income and explain how they fit into the overall scheme of taxation described above. Here we are dealing with income that is earned directly by a foreign company. In the next section we will take up the issue of income earned through U.S. subsidiaries or affiliated companies.

#### 10.3.1 Income from Investment Activities

A foreign corporation’s income from investment activities in the United States will typically generate FDAP income or gains from the sale of investment assets. FDAP income is taxed on a gross basis at a flat 30 percent rate (or lower treaty rate) and gains from the sale of investment assets may or may not be subject to U.S. tax. Companies that earn only FDAP income which is subject to withholding or that have gains that are not subject to U.S. taxation will typically be exempted from U.S. income tax return filing requirements. However, when gains from investment assets are subject to U.S. taxation, a foreign company is required to file a U.S. income tax return.

Investment activities include investing in securities of U.S. companies, securities of federal or state governmental units, and income from non-business assets. These assets will include stocks and bonds of U.S. companies, bonds of federal, state and local governments, investments in U.S. real property, and licensing intangible property for use in the United States.

Investment in stocks of U.S. corporations will give rise to dividend income and gains from the sale of the stock. Dividends paid by a U.S. corporation are considered U.S. source income and subject to a 30 percent withholding tax (or lower treaty rate). Gains from the sale of corporation stock by a non-U.S. company will generally not be subject to U.S. tax. However, if more than 50 percent of the value of the corporation is attributable to U.S. real property interests, the gain from the sale of the stock is taxable in the United States.
Equity investments in non-corporate U.S. companies are treated differently than investments in corporate stocks. Non-corporate entities (partnerships and limited liability companies taxed as partnerships) are taxed on a flow-through basis. This means that the equity owners of these entities are subject to U.S. tax on their allocable share of the income of the entity. The nature and character of the income carries over to the owner. Therefore, if the entity has effectively connected income, the owner will have effectively connected income. The owner is required to file a U.S. tax return reporting the income. Furthermore, gains from the sale of the equity interest, unlike gains from the sale of corporate stock, may be subject to U.S. tax.

In order to aid the collection of tax due from foreign equity owners of U.S. partnerships and limited liability companies, U.S. tax law requires the entity to remit 35 percent of the foreign owner’s share of the entity’s income. This remittance is considered a withholding tax and is treated as a distribution to the owner. When the owner files its U.S. tax return and reports its share of the entity’s income, it is entitled to a credit for this payment.

Investments in U.S. debt instruments will generate interest income and gains from the sale of the assets. Interest income paid by U.S. persons is U.S. source income and is subject to a 30 percent withholding tax (or lower treaty rate). Interest on most debt instruments issued by state and local governments are exempt from federal taxation. Gains from the sale of debt instruments are sourced to the residence of the seller and are considered foreign source income that is not subject to U.S. tax. However, a portion of these gains may be recharacterized as interest income and subject to U.S. tax.

There are two important exceptions to the taxation of interest income—the bank interest exception and the portfolio interest exception. The bank interest exception excludes interest income earned by non-U.S. persons from domestic bank deposits. The portfolio income exception excludes interest income earned by non-U.S. persons from certain investments in debt securities of unrelated parties. These provisions are designed to encourage the flow of investment capital into the United States; and together, they prevent taxation of most interest paid from U.S. persons to unrelated foreign parties.

The tax consequence of investments in U.S. real property differs depending on the nature and use of the real property. To better understand these differences, let us consider three classes of investments: (1) non-income generating investment real property, (2) real estate development activities, and (3) rental real estate operations.

The non-income generating class of real property investment involves investments in property where no current income or loss is generated, and investment returns are realized through appreciation and sale of the property. Gains from this type of investment are subject to U.S. taxation.

Real estate development activities involve the production of units of real property for sale in the ordinary course of business. This includes the subdivision of land, the production of residential housing lots or the construction of multi-unit condominiums. Income from development activities is considered business income and is taxed on a net basis at graduated
income tax rates. Foreign companies undertaking such activities are involved in a U.S. trade or business and should consider the discussion under Section 10.3.2.

Rental real estate operations may, or may not, rise to the level of a U.S. trade or business. To illustrate, let us look at two extreme examples. First, ownership of one property that is subject to a net lease (the tenant is responsible of all costs associated with the property) will not constitute a U.S. trade or business. Rental income from such an investment would be taxed on a gross basis at a flat rate of 30 percent and gains from the sale of the property are subject to U.S. tax. On the other hand, the operation of a vast portfolio of real estate holdings that are actively managed by the foreign company is considered a U.S. trade or business. It is subject to tax based on its net income from U.S. operations at graduated tax rates. Gains from the sale of the properties are subject to U.S. taxation. Foreign corporations undertaking such activities should consider the discussion under Section 10.3.2.

There is no clear guidance on what lies between these two examples; no simple way to determine when real estate activities are considered a passive investment and when they are considered a trade or business. Accordingly, it may be difficult for a foreign company to determine the proper treatment of its activities. An election is available to alleviate this uncertainty. Under this provision, a foreign company may elect to treat all of its U.S. rental activities as an active trade or business.

Sales of all classes of real property are subject to a withholding regime designed to assure compliance by foreign taxpayers with U.S. tax laws. Under this regime, the purchaser of real property is required to withhold and remit 10 percent of the purchase price if the seller is not a U.S. person. When the seller files its required U.S. tax return, a credit is allowed for the amount withheld. In certain cases where the 10 percent withholding tax will exceed the seller’s tax liability with respect to the sale, the seller may be able to petition tax authorities to reduce or eliminate the withholding requirement.

As a general rule, a foreign company’s income from the license of intangible property for use in the United States will generate royalty income that is taxed on a gross basis at a flat 30 percent rate (or lower treaty rates) and gains from the sale of such intangible property are taxable in the United States.

This general rule can be misleading. The reason is that the determination of whether a transaction is viewed as a license of intangible property or some other type of transaction (such as a sale of goods or a sale of intangible assets) depends on federal tax law and not on the governing intellectual property law. Federal tax law views transactions with respect to intellectual property differently than do most intellectual property laws. The result is that transactions may be classified differently than expected. For instance, it is common for software product licenses to be classified as the sale of goods for tax purposes. Likewise, a license to use a technological process over a geographic area may be classified as a sale of the intellectual property.
10.3.2 Income from Business Activities

A foreign company’s income that is effectively connected with a U.S. trade or business is taxed on a net basis (income less related deductions) at graduated tax rates. Foreign companies engaged in a U.S. trade or business are required to file a U.S. tax return, even if all of their business income is exempt from U.S. taxation by virtue of an income tax treaty.

The term U.S. trade or business is often referred to in U.S. tax statutes and regulations; unfortunately, nowhere in these statutes and regulations is it defined. The definition has been left to the courts. The result is that no clear definition exists.

Any attempt to define U.S. trade or business must address the term’s two components—that there be a trade or business and that it be conducted in the United States. A trade or business must be conducted with regularity; one-off transactions do not constitute a trade or business. However, regularity should not be confused with frequency. One or two transactions per year—every year—will occur with regularity, even though infrequent.

A trade or business is considered to be conducted in the United States if the business activities give rise to effectively connected income. As a technical matter, it is possible that a trade or business could be conducted in the United States that does not give rise to effectively connected income; but from a practical standpoint, such activities will not be subject to U.S. taxation. Therefore, we will consider a U.S. trade or business to be any business activities that are conducted with enough regularity to rise to the level of a trade or business and that generate effectively connected income.

Effectively connected income consists of three types of income.

1. **Certain FDAP Income and Related Gains** – U.S. FDAP income and U.S. source gains that arise from the sale of assets that give rise to FDAP income is effectively connected income if they meet either the asset-use test or the business-activities test. The asset-use test is met if the assets that give rise to the income or gains are held for use in the conduct of a U.S. trade or business. The business-activities test is met if the activities of the U.S. trade or business are a material factor in the realization of the income or gains.

2. **U.S. Source that is not FDAP or FDAP Related Gains** – All U.S. source income that is not FDAP or gains that arise from assets that give rise to FDAP income will be considered effectively connected income.

3. **Certain Foreign Source Income** – There are three classes of foreign source income that are included in the definition of effectively connected income: (1) income derived from the use or the privilege of using intangible personal property in the United States; (2) dividends, interest and gains from the sale of securities related to the active conduct of a banking or financing business in the United States; and (3) income from the sale of inventory outside the United States that is attributable to activities of a U.S. office of the taxpayer.
It is not necessary for a foreign corporation to have employees or property in the United States in order to become subject to U.S. taxation on its business income. Selling products to customers in the United States may be enough, even if sales orders are taken by representatives located outside the United States over the telephone or Internet. The important factor is where the risk and benefits of ownership of the property transfers from the seller to the buyer. If this transfer occurs in the United States, the sale is considered U.S. source effectively connected income.

Another common situation that gives rise to U.S. taxation is where a foreign corporation’s employees periodically visit customers in the United States to provide services (such as merchandising, training and installation services). Income derived from services performed in the United States is U.S. source business income. It does not matter if the services are infrequently performed (say, only a few times a year) as long as they occur on a regular basis. It also doesn’t matter if the foreign company does not bill separately for these services. For example, a foreign company may sell goods to U.S. customers with title transfer occurring outside the United States. The sales transaction is foreign source income. However, the value of any related services performed in the United States included in the sales price is U.S. source income subject to taxation.

Once a company has determined its gross income subject to U.S. taxation, it must determine the allowable deductions. This is a two-part process that involves the calculation of allowable deductions and the allocation of those deductions between effectively connected income and income not subject to U.S. taxation on a net basis (i.e. FDAP and foreign source income that is not effectively connected with the U.S. trade or business).

U.S. tax accounting rules differ from both U.S. and international generally accepted accounting principles. The company’s accounting expenses must be adjusted to reflect differences in both the type of deductions allowed and the timing of those deductions. These deductions must then be allocated between effectively connected income and other types of income under complex allocation provisions contained in the statutes and regulations. This allocation may also be affected by transfer pricing provisions.

Income tax treaties play an important role in the taxation of business activities because they substantially alter the rules described above. Most U.S. income tax treaties contain a clause that limits the ability of the United States to tax the business profits of foreign companies. Such business profits are not taxable unless they are attributable to a permanent establishment located in the United States. A permanent establishment usually arises as the result of a fixed place of business (such as an office, a factory, distribution facility, or long-term construction location) located in the United States, or the presence of an employee or agent in the United States who habitually exercises the authority to enter into contracts on behalf of the foreign company.

Therefore, foreign companies that are entitled to treaty benefits are significantly less likely to be subject to U.S. taxation on their business profits. However, a foreign company that carries on a U.S. trade or business must file a U.S. tax return even if its business profits are nontaxable by virtue of the permanent establishment provisions of an income tax treaty. This filing is designed
to give notice to the tax authorities that the company is claiming treaty benefits; thereby giving
them opportunity to challenge the company’s position with respect to the treaty exemption.

10.4 U.S. SUBSIDIARIES AND AFFILIATES OF FOREIGN COMPANIES

Foreign companies frequently choose not to do business directly in the United States; but to
do so indirectly through the use of subsidiaries and affiliate companies. There are many reasons
for this, and while tax considerations may be important, liability and operational considerations
are often more important. This section will describe how a few common subsidiary and affiliate
structures are taxed in the United States.

10.4.1 U.S. Subsidiary Corporations

Perhaps the most common structure is for a foreign corporation to form a U.S. subsidiary
corporation under U.S. domestic law. In this case, the foreign parent is considered a foreign
corporation and is taxed under the provisions discussed in the previous section. The subsidiary is
a domestic corporation and is subject to U.S. taxation on its worldwide income.

This structure is often designed so that the U.S. subsidiary earns only U.S. source income and
the foreign parent (or other foreign affiliates) earns only non-U.S. business income. In this way,
the parent limits its exposure to U.S. tax liabilities and is not subject to the complex cost
allocation regime while the U.S. subsidiary avoids foreign income that could be subject to the
anti-deferral rules.

It is common for a U.S. subsidiary to own additional U.S. subsidiaries. This is done to
segregate business operations and limit liability exposure. U.S. tax law allows certain U.S.
parent subsidiary groups to elect to file a consolidated tax return. This consolidated tax return
will include only eligible U.S. corporations. Foreign corporations are generally excluded. The
major advantages of filing a consolidated return is that losses from one subsidiary may be used to
offset income from profitable subsidiaries and taxation of profits from transactions between
members of the consolidated group are deferred.

The consolidated tax return rules are complex and may lead to unexpected results in certain
circumstances. An alternative to this structure is to form the U.S. corporation’s wholly owned
subsidiaries as limited liability companies. The limited liability companies can elect to be
disregarded for U.S. tax purposes thereby eliminating much of the complexity associated with
the consolidated tax return rules while still allowing for the major benefits of consolidation.

10.4.2 Financing U.S. Subsidiaries

Decisions regarding the mode of financing operations of a U.S. subsidiary involve several tax
considerations. This is particularly true when the funding comes from the foreign parent. The
parent can choose to provide this financing either in the form of debt or equity, and there are
advantages and disadvantages to both.
A major advantage to the use of debt is that it allows profits to be stripped out of the United States (whose corporate tax rates are higher than most of its trading partners) with tax-deductible interest payments. It also allows funds to be repatriated to the home country via principal payments that are not subject to U.S. withholding tax. A potential downside to debt is that if the U.S. subsidiary suffers operating losses, there may be no immediate benefit to the interest deduction in the United States, while the interest income earned by the parent may be subject to both U.S. withholding taxes and income taxes in the home country.

U.S. tax law contains two important provisions designed to protect against erosion of the U.S. tax base through the use of related party debt and tax-deductible interest payments. The first of these are the thin capitalization rules. These rules apply to companies that have a debt-to-equity ratio greater than 1.5 to 1.0. Under these provisions, the deduction for interest payments on debt issued or guaranteed by related parties is limited to 50 percent of adjusted taxable income (adjusted taxable income is based on the operating cash flow of the corporation). The limitation is calculated each tax year and disallowed deductions may be used in future years, subject to that future year’s limitation.

The second provision allows tax authorities to reclassify certain debt as equity. In the context of the debt of a U.S. corporation to a foreign related party, debt instruments are most likely to get reclassified as equity where one or more of the following factors exist.

1. The rate of interest deviates from market rates.
2. The U.S. subsidiary has a high debt-to-equity ratio.
3. Debt due to shareholders is held in the same or similar proportion as the equity interests.
4. The debt is subordinated to the interest of third parties.
5. The debt is convertible to equity.

If a debt instrument is recharacterized as equity, both interest and principal payments are treated as dividends to the extent of the accumulated earnings and profits of the U.S. subsidiary. This means that interest deductions will be disallowed and that principal payments may be subject to withholding at rates as high as 30 percent.

10.4.3 Transfer Pricing

Any time there are transactions between related parties, the taxpayer will have to consider transfer pricing issues. The transfer pricing rules in the United States affect many different types of transactions. These include the sale of goods, the provision of services, the use of tangible or intangible property, interest rates on loans, and cost-sharing arrangements.

U.S. transfer pricing regulations require that prices charged between related parties meet the “arm’s-length standard”: prices charged must be the same or similar to what would be charged between unrelated parties in the same or similar circumstances. The methodology used to
calculate price depends on the type of transaction (e.g. sale of goods, provision of services, and use of intangibles). For most transactions, there are several methodologies available and the taxpayer must determine which methodology is considered the “best method,” given its particular facts and circumstances.

Development of a supportable transfer price requires gathering comparable data from similar transactions made between unrelated parties. This data may come from transactions entered into between the taxpayer and third parties or from publically available data. In either case the information must meet the regulation’s comparability standards. These standards require that the data used be from transactions where the functions performed, the contractual terms, the risks, economic conditions and products or services are all comparable to the transaction in question.

Taxpayers may be subject to significant penalties if their tax liability is adjusted under the transfer pricing regulations. A penalty equal to 20 percent of the additional tax assessed will apply if the transfer price charged is more than 200 percent (or less than 50 percent) of the correct price or if the amount of the tax adjustment related to transfer pricing adjustments exceeds the lesser of $5 million or 10 percent of the taxpayer’s gross receipts. This penalty is increased to 40 percent of the additional tax assessed if the transfer price charged is more than 400 percent (or less than 25 percent) of the correct price or if the amount of the tax adjustment related to transfer pricing adjustments exceeds the lesser of $20 million or 20 percent of the taxpayer’s gross receipts.

The taxpayer may avoid these penalties if it can establish that it has met the following three requirements.

1. The taxpayer must determine its transfer price in accordance with a specific method set forth in the regulations.
2. The taxpayer prepares documentation which sets forth the determination of such transfer price in accordance with the specified method and establishes that the use of that method is reasonable. This documentation must be in existence at the time the tax return is filed and must contain all the elements required under U.S. tax law.
3. The taxpayer provides such documentation to the Internal Revenue Service within 30 days of a request for documentation.

### 10.4.4 Pass-Through Entities

While foreign companies will often use a U.S. subsidiary corporation to operate in the United States, other entities are available. These entities include partnerships and limited liability companies. Foreign-owned U.S. corporations are considered separate taxpaying units; however, partnerships and limited liability companies may elect to be taxed on a pass-through basis. Under certain circumstances this may offer tax advantages to foreign companies.

Partnerships must have two or more partners, at least one of which has unlimited liability. The partnership is not a tax-paying entity; rather, each partner files a U.S. tax return and pays tax
on its share of the partnership’s income. Limited liability companies can have one or more owners. If it has more than one owner, it is taxed in the same manner as a partnership. If it has one owner, it is disregarded for tax purposes; meaning that all of the assets, liabilities, income and deductions of the company are considered to be assets, liabilities, income and deductions of the owner.

Limited liability companies offer many tax advantages to U.S. owners. However, these same advantages do not always carry over to foreign owners. Therefore, foreign companies or individuals should carefully consider both U.S. and foreign tax consequences before acquiring an interest in such an entity.