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U.S. Withholding Considerations for International Grants by U.S. Funders

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This paper discusses situations where a U.S. grant maker may be exposed to liability as a withholding agent in respect of grants made to foreign grantees.

The U.S. Regime for Taxing and Withholding Tax on Payments to Foreign Persons

The United States follows the pattern of many countries in taxing at source U.S.-source income of a foreign person in one of two ways. Income connected with a U.S. trade or business is taxed on a net basis with business and certain other deductions allowed against the U.S.-connected income. U.S.-source income not connected with the U.S. business is taxed on a gross basis at a flat rate of 30 percent, unless a treaty applies.[1] This gross basis tax is collected by withholding.[2] Indeed, certain U.S. income subject to the net basis tax is within the obligation to withhold tax unless the person with the withholding obligation, the withholding agent, has documentary support for not withholding tax.

Importantly for international grant makers, a U.S. payor of U.S.-source income is a withholding agent and a withholding agent is subject to joint and several liability for tax that is subject to withholding. Accordingly, a U.S. grant maker may be exposed to liability as a withholding agent in respect of grants made to foreign grantees where some of the activities to satisfy the grant purposes are performed in the United States or might otherwise constitute U.S. source income.

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[1] I.R.C. §§ 871(a) and (b), 881, 882.
[2] I.R.C. §§ 1441, 1442.

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When Does Withholding Tax Exposure Arise?

Thirty-four years ago (to rub it in), Professor Dale wrote the leading article on withholding tax on payments to foreign persons.[3] Professor Dale laid out 6 questions that must be answered to determine whether withholding is required. The questions, slightly modified, are equally relevant today:

1. Is the recipient a foreign person, *i.e.,* a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate?
2. Does the amount being paid include income from sources within the United States?
3. Does the amount being paid include income of the type generally described as "fixed or determinable annual or periodical"?
4. Does the payment include income which is *not* effectively connected with the conduct of a trade or business within the United States by the recipient?
5. Is the payor or some other person in the transaction a "withholding agent"?
6. Is there no exception applicable to the particular circumstances in question which might cut off the requirement of withholding tax?[4]

For purposes of this discussion, we will assume that the recipient is a foreign person, that the amount being paid is "fixed or determinable," that the payor is a U.S. person and a withholding agent. The questions left are when a grant payment is "U.S. source" and, indeed, when is it "gross income"? This seems like the wrong order to take the questions, but it is the most efficient order.

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[3] Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX LAW REV. 49 (1980) (hereinafter "Dale, *Withholding*").
[4] Dale, *Withholding*, *supra* note 3, at 53.

When Is Grant Income U.S. Source Subject to Withholding?

Assuming that the a grant payment is considered income, if the performance of the grant occurs wholly outside the United States, it is very unlikely that it could be characterized as U.S.-source income (this assumes that the grant would not constitute payment of a royalty or interest on an obligation or for the purchase of goods). The signal area of difficulty arises if performance of the grant entails or results in the grantee performing service activity in the United States that could be construed as in whole or in part paid for by the grant. The issue is presented most clearly when the grantee will pay for persons to attend meetings or conferences in the United States in fulfillment of obligations under the grant. Income from services, whether performed by individuals or by entities (through their agents) is sourced according to the place of performance.[5] While U.S. services nearly always constitute a U.S. trade or business and, usually, U.S. business income is excluded from withholding, compensation for services is an exception to the exclusion from withholding.[6]

If a payment is for U.S. source fixed or determinable income, the U.S. withholding agent has an obligation to withhold tax unless an exception applies. One exception would be if the grantee is properly classified as qualifying as a section 501(c)(3) organization; however, in order to rely on this exception, the foreign organization must provide the withholding agent with a Form W-8EXP based on either receiving a determination letter from the I.R.S. or an opinion of counsel concluding that recipient is described in Section

[5] I.R.C. §861(a)(3). The services source rule has a de minimis exception that is narrow and does not apply to services performed by an entity. Additional difficult issues of interpretation are presented if services are performed through independent agents in the United States. See, e.g., Le Beau Tours Inter-America, Inc. v. United States, 415 F. Supp. 48 (S.D.N.Y.), aff'd, 547 F.2d 9 (2d Cir. 1976); Miller v. Commissioner, 73 T.C.M. (CCH) 2319 (1997). For purposes of this discussion, we will assume that at least some part of a payment is U.S. source.

[6] There is a miniscule exception from the definition of U.S. source income for services performed for 90 days or less in the United States by an individual for which an employer pays less than $3,000 (if no U.S. compensation deduction is allowed) and certain conditions are satisfied. (The $3,000 cap would yield less than three hours of some lawyers' time.) I.R.C. §861(a)(3). The reason why the resulting U.S. services income is subject to withholding is a clause in Section 1441(c) that carves out compensation for personal services from the withholding exception for U.S. connected business income. Voilà, the outcome is withholding of tax on a payment in respect of a nonresident's income from U.S. personal services even if such income is effectively connected with a U.S. trade or business and thus, ultimately, subject to net-basis taxation.

501(c).[7] This exception is difficult for many grantees to take advantage of and is rarely useful.

When Is a Grant Not Gross Income?

In Private Letter Ruling 200529004 (April 11, 2005) the I.R.S. held that a grant to a foreign grantee, which included payments for persons performing services for the grantee to attend and make presentations regarding the project in the United States, was a gift and withholding would not be required. The private ruling was given by the Office of Associate Chief Counsel (International), was based on a limited factual description and representations, and was conclusory in its analysis. It is very difficult to reconcile the result with the usual application of the Duberstein test that gifts proceed from "detached and disinterested generosity . . . out of affection, respect, admiration, charity or like impulses."[8] In 2008, the I.R.S. announced that it would not rule on gifts because the analysis is highly fact specific. Notwithstanding that the ruling carries no precedential weight, serious funders have sought to use the ruling as a basis for positions that withholding is not required with respect to cross-border grants. There are grounds for skepticism that a gift analysis would hold up in many cases under a full review of the facts and objective application of the income tax standard for what constitutes a gift.

What to Do?

The situation is a bit of a mess, but all hope is not lost. What are the options?

- Withhold on payments.
  - The funder would be protected from risk of liability for taxes and penalties, but:
  - The administrative requirements for withholding are complex and costly, and

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[7] The Form W-8EXP must include a valid taxpayer identification number and the withholding agent still is obligated to report the payment to the I.R.S.
[8] *Comm'r v. Duberstein*, 363 U.S. 278 (1960).

    - Program costs would be materially increased, possibly disproportionately because of the administrative costs and, particularly, if the payment is grossed-up for the tax.
- Treat payments as non-taxable because paid to a qualified tax-exempt payee.
    - The funder would be protected from risk of liability for taxes and penalties, but:
    - The administrative requirements for evidencing exemption also are costly,
    - The solution would not be available for many grantees because of the nature of their program activity, and
    - Even where exemption may be established, program costs would be increased.
- Treat payments as non-taxable gifts.
    - This approach holds material risks in the event of audit in a wide range of likely cases, but
    - The I.R.S.'s TE&GE Division has scarce audit resources, has not evidenced an interest in this issue, and lacks technical knowledge of the international area,
    - Existing authority may be sufficient to stave off dire consequences.
- Draft a grant to exclude payment for U.S. source services.
    - "This grant is exclusively for services performed outside the United States."
    - How much further might the drafting go? "Foundation X regularly holds conferences in the United States to which the grantee's personnel may be invited; however, no part of this grant may be used for services performed inside the United States. Foundation X, however, makes an unrestricted grant of $100,000 for core support."
    - Is this too squirrely? If so, what is the downside of such drafting, if any?
- Lobby for more favorable law and/or regulations.
    - Likely there would be a sympathetic ear for finding a practical resolution for these issues, but
    - The law is not good for taxpayers on these issues,

  - The I.R.S.'s TE&GE Division has scarce resources generally, is under considerable political pressure, has not evidenced an interest in giving this issue priority, and would require involvement of international offices that may have competing considerations.
- Let sleeping dogs lie – (one could hope tax reform comes around and presents an opportunity for change). Need one say more?

This is a classic risk profile issue. Like frequent flier miles, there would seem to be little percentage for the government to pursue the issue; however, political craziness can alter this equilibrium. Moreover, when a taxpayer perceives that its risk-reward calculus is not to its liking, a precedent of withholding will be established and the issue also could come to the fore. [9]

[9] See *Shankar v. Commissioner*, 143 T.C. No. 5 (Aug. 26, 2014) (Judge Halpern upholding I.R.S. position that taxpayer use of frequent flyer miles granted by Citi for maintaining account the use of which was reported by Citi on 1099-MISC as gross income).

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International Allocation and Apportionment of Charitable Deductions

Stephen E. Shay* and Harvey P. Dale**

This paper discusses the U.S. tax rules for allocation and apportionment of charitable deductions for purposes of determining a taxpayer's foreign tax credit limitation. It suggests that the rules are overly generous in apportioning charitable deductions to U.S. income and away from foreign income. As a consequence, the rules inappropriately expand allowable foreign tax credits.

The U.S. Regime for Taxing Foreign Income of U.S. Persons

A U.S. person generally is taxed on her worldwide income, including income that may be taxed by a foreign country. Generally, the United States allows a taxpayer to elect to credit a foreign income tax against U.S. taxes on foreign-source (net) income. The amount of foreign tax allowed as a credit is limited to the foreign income taxes paid or deemed paid by that taxpayer on income in a foreign tax credit limitation category up to the amount of U.S. tax on foreign net income in the same category.[1] Since 2004, the principal foreign tax credit limitation categories have been foreign-passive category and foreign-general category income.

"Foreign net income" for purposes of the limitation is determined under U.S. tax principles. For these purposes, foreign net income is foreign source gross income reduced by expenses allocated and apportioned to the foreign gross income.[2] "Allocation"

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[1] I.R.C. §§ 901, 904. Foreign taxes that exceed the relevant limitation for the category generally may be carried back one year and forward 10 years. I.R.C. §904(c).

[2] The rules for allocating and apportioning expenses are principally found in regulations at Reg. §§1.861-8 through -17, 1.863-0 through -3. These rules guide the allocation and apportionment of deductions for the

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connotes a direct relationship, i.e., the expense can be "located" as relating to specific items of gross income, whereas "apportionment" connotes pro rating, i.e., the expense is not directly related to any specific item of gross income and thus only some "portion" of it is deductible against each such item.

Allocation and Apportionment of Expenses for the Foreign Tax Credit Limitation

To determine foreign net income for purposes of the foreign tax credit limitation, expenses are allocated to a "statutory grouping" of gross income; in the case of the foreign tax credit limitation the "statutory grouping" is foreign source income in a separate limitation category. If the expense is allocable entirely either to the statutory grouping, e.g., it is allocable to foreign-source-general category income, no apportionment is necessary. If the grouping of gross income includes income not within the statutory grouping, such as U.S. income or foreign-passive category income, the expense must be apportioned on some reasonable basis between the statutory grouping and gross income not in the statutory grouping.

Several categories of expense, including deductions for interest, R&D, and income taxes, are allocated and apportioned under rules intended to take account of the particular character of the expense.[3] If an expense cannot be associated with a grouping of gross income, it may be considered "not definitely related to any gross income." In that case, the expense normally would be ratably apportioned between all of a taxpayer's gross income within and outside of the statutory grouping.[4]

Although the technically correct "statutory grouping" for purposes of the foreign tax credit limitation is foreign source income in the relevant foreign-tax-credit limitation category, if all of the taxpayer's foreign source gross income is in the general category, the limitation issue is simply whether the taxpayer has U.S. or foreign-source net income. The

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foreign tax credit limitation under Section 904, which is referred to as an operative section, as well as for other operative sections. Operative sections other than Section 904 are listed at Reg. §1.861-8(f)(1).

[3] See American Bar Association Section of Taxation, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 765-771 (2006) (critically reviewing interest and research and experimentation expense allocation rules).

[4] *See* Reg. §1.861-8(e)(9).

remainder of this paper will treat all foreign-source income as though it were the statutory grouping (which is the common practice because the foreign-passive category typically is quite small), and shall refer to the allocation and apportionment of expense as between U.S. and foreign source income.

<u>The Stakes in Allocating and Apportioning Deductions under Current U.S. Worldwide (with Deferral) Tax System</u>

The allocation and apportionment of deductions to foreign-source income reduces the foreign tax credit limitation while allocating (or apportioning) a deduction to U.S. income expands the foreign tax credit limitation by not reducing net foreign income by the deduction. Since a U.S. resident taxpayer is taxed on her worldwide income in any event, it is almost always advantageous to have more foreign-source income because the foreign tax credit limitation is increased – there is rarely a downside to allocating an expense away from foreign income.

> Example 1: Harriet has 200 of income before tax. For simplicity, assume all of her income is subject to Federal tax at a 35% rate. We further assume that (i) 100 of Harriet's income before tax is foreign net income in the general category, (ii) Harriet paid 35 of foreign tax, and (iii) Harriet elected to take a foreign tax credit.[5] Harriet's foreign tax credit limitation would be 35 (100 * 35%). Harriet would claim a foreign tax credit of 35 and pay U.S. tax of 35.

In Example 1 Harriet's foreign tax credit is not limited and all the foreign taxes may be used to offset (in this case completely) her U.S. tax on her net foreign income. Now assume that Harriet has 20 of additional U.S. income and 20 of expense allocable solely to foreign-general category income.

> Example 2: The facts are the same as in Example 1, except Harriet has 20 of additional U.S. income and 20 of expense allocable solely to foreign income.

[5] If a taxpayer elects to take a foreign tax credit, then potentially creditable income taxes are not allowed as a deduction, whether or not they exceed the foreign tax credit limitation, and any excess of such taxes must be carried over as potential creditable taxes in the carry-over years.

Harriet's worldwide net income before tax remains 200. Harriet's foreign net income, however, is 80 (100 foreign gross income – 20 expense allocable to foreign income) and her foreign tax credit limit is 28 (80 * 35%). Harriet would claim a foreign tax credit of 28 and pay U.S. tax of 42 (70 – 28).

Harriet's worldwide net income and her foreign source gross income are unchanged from Example 1. Her net foreign income, however, now is reduced (by 20 of expense) to 80, her U.S. tax on the foreign net income is 28, and she can only credit 28 of foreign taxes. Harriet pays 42 of U.S. tax, or 70 of tentative U.S. tax on 200 income, reduced by a now-limited 28 credit for foreign income tax. Her total U.S. and foreign tax combined increases from 70 to 77 (35 foreign tax + 42 U.S. tax) and her "global" effective rate of tax increases from 35% (70/200) to 38.5% (77/200).

Example 2 demonstrates that where the limitation is constricting, the allocation of the expense is very important and can effectively result in denial of the benefit of the deduction. Today, an increasing number of taxpayers experience the opposite, i.e., they have unused (or excess) foreign tax credit limitation. Explanations include declining foreign corporate tax rates, increased success at avoiding foreign taxes, ease of earning income treated in whole or in part as foreign for U.S. tax purposes that rarely is taxed by foreign countries (e.g., income from export sales and foreign royalties), and other idiosyncratic reasons. In such a case, allocation and apportionment of deductions between U.S. and foreign income is unimportant because the foreign tax credit limitation is not constricting; the taxpayer may use the credit for whatever foreign income tax is paid. As discussed below, if the United States shifts to exempting foreign business income, the issue of allocating and apportioning deductions to exempt foreign income may be important in every case, *if* allocation or apportionment of the deduction to exempt income results in disallowance of the deduction.

Allocation and Apportionment of Charitable Deductions

The regulations are generous toward the allocation and apportionment of charitable deductions. While the regulations specify that a charitable deduction allowed

under Section 170 "is definitely related and allocable to all of the taxpayer's gross income," they do not provide for pro rata apportionment between all of a taxpayer's U.S. and foreign income. Instead, the regulations effectively cause the deduction to be apportioned to U.S. source income, irrespective of whether the deduction benefits foreign or domestic charitable activity.[6]

The regulations take a different approach to charitable deductions that are allowed by treaty. The U.S. tax treaties with Canada, Mexico, and Israel provide, subject to limitations, deductions for charitable contributions to charities in those countries.[7] Under the regulations, if a charitable deduction is allowed by treaty that otherwise would not be allowed and if the deduction is subject to a limitation based on income from the treaty partner, then the deduction is apportioned among categories based solely on income from that country.[8] This approach in effect prevents the special treaty allowance of the charitable deduction from also expanding the taxpayer's foreign tax credit limitation by being allocated away from foreign income (as it would be under the general rule of the regulation). If the donor is subject to full taxation in the treaty partner country and if the foreign country does not allow a comparable deduction, the apportionment rule can cause some or all of the benefit of the deduction to be lost.

1991 proposed regulations would have provided that a charitable deduction is allocated to the United States if it was designated to be used in the United States and it was reasonably expected to be used there. The deduction would be allocated to foreign income if it was designated for use outside the United States and the taxpayer reasonably believed that it would be. Any deductions not allocated under the preceding rules would be

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[6] In masterfully opaque language, the regulations provide that the deduction "shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping." Reg. §1.861-8(e)(12)(i). This means that, effectively, the charitable deduction will not reduce the foreign tax credit limitation.

[7] U.S. – Canada Income Tax Convention, Art. VVI(6); U.S. – Israel Income Tax Convention, Art. 15A(1); U.S. - Mexico Income Tax Convention, Art. 22(2)(b).

[8] The language is equally opaque. The regulation provides in part: "The deduction allocated under this paragraph (e)(12)(ii) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping." Reg. §1.861-8(e)(12)(ii).

apportioned on a ratable basis between U.S. and foreign income.[9] Notwithstanding that the proposed regulations aligned the deduction with the location benefitted by the contribution, these regulations were never made final. We mention them because a shift to a territorial system of taxing foreign income should, as a normative matter, increase the pressure to revisit the allocation of deductions between U.S. and exempt foreign income.

Allocation and Apportionment of Deductions in a "Territorial" System

A number of tax reform proposals would shift the United States from a worldwide-with-deferral system, for taxing foreign business income, to an exemption system. In an exemption system, the same issues pertaining to allocation and apportionment of deductions arise as in a worldwide system. In both cases, the issue is properly measuring the foreign and U.S. net income. In a territorial system, however, the issue is no longer just whether to allow a foreign tax credit, but is whether to allow the deduction (against U.S. gross income) of expenses allocable to foreign income that is exempt from home country tax under the territorial system.

Most countries do not have highly developed expense allocation and apportionment rules such as those in the United States, and most countries adopting a territorial system address the issue more simply by only allowing 95% exemption for the relevant foreign income and deeming 5% as an effective expense disallowance. This also is the approach proposed in most of the U.S. territorial proposals. Nonetheless, the failure to allocate and apportion deductions on a measurement-of-income basis is a source of revenue loss. One could anticipate that, in order to achieve lower headline tax rates, tax reformers would reach for nontransparent ways to expand the tax base. This perfectly describes allocating expenses to exempt foreign income and disallowing such allocated expenses.

Normative Considerations

In the view of some scholars, the charitable deduction does not have a strong

[9] Prop. Regs. §1.861-8(e)(12) (1991).

normative foundation.[10] It is a non-business deduction that does not produce a stream of income for the donor. While it is argued that a charitable donation does not represent personal consumption, that seems wrong in many cases where the donation is for an activity favored and used by the donor. As is so often the case with tax law provisions not securely grounded in income measurement, second best alternatives are required to address collateral issues.

If the benefit of a charitable expenditure is clearly foreign, because that is where the beneficiary resides and carries on activities, should the deduction be allocable to and burden foreign income? Does the expenditure give rise to or benefit income from where it is used or should it be associated with income from that source? Or, is the expenditure "consumed" at the residence of the donor? How should the different approaches between the non-treaty and treaty-based charitable deductions be reconciled? Is the treaty rule based solely on revenue protection? If so, why does it not apply comparably to all charitable deductions?

Once allowed as deduction, it seems strange to allow the donation for contributions to benefit foreign charitable activity and yet allow that some contribution to be used to offset domestic income. That is a subsidy for foreign as opposed to domestic economic activity.[11] Moreover, in a territorial system, allocating an expense appropriately is comparable (inversely) to allocating expenses to unrelated business income. If the charitable deduction is allocable to exempt foreign income, it should not be allowed as a deduction against U.S. source income.

It may be argued, correctly, that in such a case the expense should be allowed as a deduction by the foreign country if the donor would be taxable there. This is rarely done,

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[10] "[D]espite the long lineage of the charitable deduction, we lack a comprehensive, coherent theory that explains successfully why governments should allow tax deductions to subsidize the current collection of qualified charitable activities and charitable organizations." Eric M. Zolt, *Tax Deductions for Charitable Contributions: Domestic Activities, Foreign Activities, or None of the Above*, 63 HASTINGS L.J. 361, 364 (2012). Other scholars disagree; the leading article (among many) is William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972)

[11] See Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. INT'L TAX'N 486 (2008).

however, if the expenditure is not incurred in that country. Moreover, the donor often will not be taxed in the source country. The issue then becomes whether the United States should in effect subsidize the foreign income by misallocating the expense to U.S. income and refunding to the taxpayer the U.S. tax attributable to the misallocated expense.

Summary

If you have made it this far and have followed the thread of the discussion, you now are aware of one circumstance where the international rules arguably are generous to cross-order charity. The authors believe that the U.S. charitable deduction allocation and apportionment rules are generous to a fault. If the revenue protection hawks start circling, the generous charitable deduction apportionment rules should be potential prey.

It is the tradition of this conference to highlight wonderfully obscure but real issues. In some cases, it is best to leave the issue alone. In other cases, such as the allocation and apportionment of charitable deductions addressed in this paper, the issue cries out for reform (well, at least to some of us).