

A Matter of Definition: "Foreign" and "Domestic" Taxpayers

by
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INTRODUCTION

Nothing is more fundamental under the federal income tax system than determining whether an individual is a domestic or a foreign taxpayer. Accordingly, the statutory rules that determine when an alien individual is a resident of the United States are worthy of critical evaluation. Issues of U.S. residency, and the consequences thereof, also arise in the taxation of corporations, partnerships, trusts, and estates. Although inquiry into these definitional issues may generate more questions than answers, the constantly increasing levels of international trade and travel warrant the raising of such concerns at this time.

It is useful—if not comforting—to remember that the difficulty encountered in distinguishing domestic taxpayers from foreign taxpayers is a difficulty that arises from the nature of our income tax system. There are those who believe that no Constitutional proscription and no rule of international law prohibit the United States from taxing all of the income of any taxpayer that it can reach.¹ Under this view, the federal government could adopt some variation of the unitary tax principle utilized by a dozen American states to reach the income of taxpayers throughout the world.² For reasons of history, practicality, comity, and a visceral sense of fairness, the federal government has chosen not to do this. It is this decision, however, which creates the need to differentiate one class of taxpayer from the other.

Once the decision to distinguish domestic taxpayers from foreign taxpayers is made, as it has been in virtually all of the nations of the world,

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1. NOIT, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431 (1962). For a more conservative view which is in accord with the broad reach of federal taxing power, see RESTATEMENT (REVISED) FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 411-412 (Tent. Draft No. 2, 1981); Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 277, 363-66 (1967).

2. For a discussion of unitary taxation, see *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); WhiteNack, *State Tax Litigation After the Container Decision*, 20 TAX NOTES 771 (1983). See also Latcham, *Worldwide Combination and the Container Case: A Perspective on Unitary Taxation*, 2 INT'L TAX & BUS. LAW. 29 (1984).

there is widespread agreement both within the United States and abroad on two fundamental principles:

- (1) Taxpayers with a sufficiently close nexus to the jurisdiction to be considered "domestic" should be taxed on their world-wide income; and
- (2) Taxpayers without such close connections to the jurisdiction should be considered "foreign" and taxed only on income that is derived from or connected with the jurisdiction.

In practice, of course, these general rules may be overlaid with exceptions or variations,³ but they remain valid generalizations.

As a result, major differences in tax liability turn on the determination of whether a taxpayer is "foreign" or "domestic". The stakes are high not only for the taxpayer but also for others whose income is linked in some way to the taxpayer. If a taxpayer is considered domestic rather than foreign, a partial list of the federal income tax effects includes the following:

- (1) The United States will tax the taxpayer's world-wide income, rather than only that portion which has a source in the United States or is effectively connected with the conduct of a trade or business in the United States;⁴
- (2) The taxpayer's direct or attributed ownership will be counted in determining whether a foreign corporation is:
 - (a) a personal holding company;⁵
 - (b) a foreign personal holding company;⁶
 - (c) a controlled foreign corporation;⁷ or
 - (d) a foreign investment company;⁸
- (3) A U.S. source will, or may be, attributed to certain items of income received by others, including:
 - (a) dividends;⁹
 - (b) interest;¹⁰ and
 - (c) alimony;¹¹

3. See, e.g., I.R.C. §893 (exclusion for compensation of employees of foreign governments and international organizations); I.R.C. § 911 (exclusion from gross income for foreign earned income of U.S. citizens or residents living abroad). [All references to I.R.C. in this Article are to sections of the Internal Revenue Code of 1954, as amended.]

4. Treas. Reg. § 1.1-1(b) (1960), as amended by T.D. 7117 (1971), T.D. 7332 (1974). Compare I.R.C. § 61 ("gross income means all income from whatever source derived") with I.R.C. § 871 (taxation of nonresident alien individuals).

5. I.R.C. § 542(c)(7).

6. I.R.C. § 552(a)(2).

7. I.R.C. § 957(a), (d).

8. I.R.C. § 1246(b)(2).

9. I.R.C. § 861(a)(2).

10. I.R.C. § 861(a)(1).

11. Trust of Welsh, 16 T.C. 1398 (1951), *aff'd sub. nom.*; Girard Trust Corn Exchange Bank v. Commissioner, 194 F.2d 708 (3d Cir.), *cert. denied*, 344 U.S. 821 (1952); Rev. Rul. 69-108, 1969-1 C.B. 192.

(4) The taxability of certain amounts in the hands of foreign persons may be affected, including:

(a) certain amounts of personal services income;¹² and

(b) gain from disposition of shares in a corporation principally holding U.S. real estate interests;¹³

(5) A foreign trust will be treated as having been created by a U.S. grantor;¹⁴

(6) If the taxpayer is a legal entity, transfers to the taxpayer will escape the special recognition provisions of sections 367 and 1491, and a U.S. grantor of the entity, if a trust, will not be taxable under section 679;¹⁵ and

(7) An individual may qualify as a shareholder of a Subchapter S corporation.¹⁶

As a broad foundation for discussing particular distinctions between "foreign" and "domestic" status, it may also be useful to reflect briefly on some of the policies which may underlie these distinctions.

First, choosing one status over the other, or changing from one to the other, should, to the greatest extent possible, involve a real choice (or change) of position. The choice should be consequential in the real world, whether the taxpayer is an individual, a corporation, a trust, an estate, or simply a tax-significant entity such as a partnership. Thus, a first step should be to identify the real connections of people and legal entities to particular countries, so that the definitions of domestic and foreign taxpayers can be based on consequential choices. Despite the difficulty in identifying the real life consequences of certain choices for legal entities, as compared with individual taxpayers, the issue of choice looms large as a criterion of domestic or foreign status. Although one taxpayer's choices may have collateral consequences for other taxpayers, the usual pattern should be to respect, to the greatest extent possible, the consequential choices made by a legal entity or an individual taxpayer.

A second identifiable policy is a logical corollary of the first. If a taxpayer's individual choices are to be the principal basis for imposing a tax, then, to the greatest extent possible, the taxpayer should neither benefit nor be harmed by separate choices made by other taxpayers to which or to whom the first taxpayer is in some way connected.

Another possible policy consideration is that the definitions of domestic and foreign taxpayers might be shaped and applied in a manner which

12. I.R.C. § 861(a)(3).

13. I.R.C. § 861(a)(5).

14. I.R.C. § 679.

15. Sections 367 and 1491 of the I.R.C. apply only to transfers to a foreign corporation. Section 679 applies only to a foreign trust.

16. I.R.C. § 1361 (b)(1)(C).

would overall yield the most revenue.¹⁷ Tax-haven countries have made the conscious decision that they can garner more revenue by extending favorable terms to some taxpayers than they could by applying stringent standards. It is quite possible that a more liberal definition of "foreign" taxpayers, and, particularly, non-resident aliens, would result in an influx of substantial additional foreign capital to the United States, and that the benefits of this foreign capital would outweigh the loss of tax revenues resulting from extension of foreign or non-resident alien status to some taxpayers currently classified as domestic.¹⁸

Cost/benefit considerations will not be taken into account in the discussion which follows for two reasons, however. The first is that such considerations are offset by the more fundamental consideration that all individuals and legal entities that benefit (or may reasonably be presumed to benefit) from their connection with the United States should share in the burden of supporting the nation through taxes. Moreover, the tax system fashioned to maximize the yield suggested by results from today's cost/benefit analysis may minimize it in years to come, and yet it would be difficult to alter fundamental tax rules with each swing in the direction of the world economy. This having been said, it would of course be naive to fashion our definitions without at least a glance over our shoulder at the consequences to the national fisc.

I DETERMINING THE STATUS OF INDIVIDUALS

A. General Considerations

U.S. Citizens. From the beginning of the federal income tax system, an individual who is a citizen of the United States has been deemed a domestic taxpayer, subject to tax on world-wide income regardless of the individual's residence or domicile. The Supreme Court quickly held this rule to be constitutional¹⁹ and in practice the rule seems to have raised few problems of interpretation.

17. The case of *Brittingham v. Commissioner*, 66 T.C. 373 (1976), *aff'd on other issue*, 598 F.2d 1375 (5th Cir. 1979), is often cited as an example of the abuse that can occur when an alien resides in the United States for an extended period and yet retains nonresident status. See, e.g., 1982 RECOMMENDATIONS OF THE ABA SECTION OF TAXATION at 47. Mrs. Brittingham was a Mexican citizen who claimed to be a nonresident alien even though for twenty-four years, from 1945 to 1968, she maintained an apartment and regularly lived in Beverly Hills, California. The Service claimed deficiencies and penalties totaling about two million dollars just for the seven-year period from 1960 through 1966, and ultimately prevailed.

The result of cases such as *Brittingham* may well be to drive the Mrs. Brittinghams who now live in the United States to other countries, with the result that the U. S. economy would lose the expenditures these people make to purchase goods and services. Certainly, if Mrs. Brittingham had known that her world-wide income would be taxed, it is quite possible that she would have remained on the Mexican side of the border.

18. Such cost/benefit considerations will not be taken into account in the discussion which follows.

19. *Cook v. Tait*, 265 U.S. 47 (1924). The provision of special rules under sections

The force of the United States' claim on the world-wide income of even its non-resident citizens is demonstrated by the *Rexach* cases,²⁰ a lengthy series of litigation involving deficiency assessments against Felix Benitez Rexach and his wife, Lucienne D'Hotelle de Benitez Rexach. Mr. Rexach renounced his American citizenship in 1958 before a U.S. consulate official in the Dominican Republic and a certificate of loss of nationality was approved by the Department of State. In 1962, however, he claimed that his renunciation of citizenship was not voluntary but had been compelled by economic pressure and physical threats. This argument was accepted and his certificate of loss of nationality was cancelled.²¹ Thereafter, the Internal Revenue Service (IRS) assessed taxes on Mr. Rexach's income for the period from 1958 through 1962. Mr. Rexach objected, claiming that since he was "owed" no benefits during this period, he "owed" no taxes. The First Circuit rejected the argument, stating that "[w]e will not hold that assessment of benefits is a prerequisite to assessment of taxes."²²

Mrs. Rexach encountered a somewhat different problem.²³ Mrs. Rexach, a native of France, was naturalized as a U.S. citizen in 1942. In 1946, she established residence in France, and, under a statute then in existence, forfeited her American citizenship in 1949 for having resided in the country of her birth for three years following naturalization.²⁴ Nevertheless, the Governor of Puerto Rico extended Mrs. Rexach's U.S. passport, and she continued to enjoy the benefits of U.S. citizenship until 1952, when the passport was confiscated and a certificate of loss of nationality was issued. Mrs. Rexach's executor contended that she should not be taxed as a citizen for the period 1949 to 1952, when she was not, under law, entitled to citizenship. The argument failed because the Court held that "fairness" and the fact that Mrs. Rexach "received the protection of [the United States] government" warranted imposition of the tax.²⁵

931-936 of the Internal Revenue Code for citizens who reside in U.S. possessions has generated minor litigation. See, e.g., *Manning v. Commissioner*, 614 F.2d 815 (1st Cir. 1980); *HMW Industries, Inc. v. Wheatley*, 504 F.2d 146 (3d Cir. 1974). Frequent amendments have been made to these rules to reflect political changes and to integrate these rules with other provisions in the Code. See, e.g., Pub. L. 94-455, § 1901, 90 Stat. 1704 (1976) (amending sections 931 and 934); Pub. L. 92-606, § 1, 86 Stat. 1494 (1972) (adding section 935).

20. See *United States v. Rexach*, 185 F. Supp. 465 (D.P.R. 1960); *United States v. Rexach*, 200 F. Supp. 494 (D.P.R. 1961); *United States v. Rexach*, 41 F.R.D. 180 (D.P.R. 1966); *Rexach v. United States*, 390 F.2d 631 (1st Cir.), cert. denied, 393 U.S. 833 (1968); *United States v. Rexach*, 331 F. Supp. 524 (D.P.R. 1971), vacated and remanded, 482 F.2d 10 (1st Cir.), cert. denied, 414 U.S. 1039 (1973); *United States v. Rexach*, 411 F. Supp. 1288 (D.P.R. 1976), rev'd, 558 F.2d 37 (1st Cir. 1977).

21. *Rexach v. United States*, 390 F.2d 631, 632 (1st Cir.), cert. denied, 393 U.S. 833 (1968).

22. *Id.*

23. *United States v. Rexach*, 558 F.2d 37 (1st Cir. 1977).

24. A successor to this statute was declared unconstitutional in *Schneider v. Rusk*, 377 U.S. 163 (1964).

25. *Rexach*, 558 F.2d at 43.

In sum, the *Rexach* cases establish that an individual will be taxed as a citizen on his world-wide income, not only when he is and knows that he is a U.S. citizen, but also when, as in the case of Mr. Rexach, he is in fact a citizen, even though he thinks he is not or when, as in the case of Mrs. Rexach, she thinks she is a citizen, even though, in fact, she is not.

Presumably, the imposition of tax on world-wide income should be related in some reasonable way to the scope of the governmental services the taxing country may fairly be presumed to be extending to the taxpayer. While the range of governmental services enjoyed by a resident no doubt exceeds that extended to the nonresident citizen, there is equally no doubt that the latter enjoys substantial legal and practical protections by reason of his nationality, not the least of which is the right of reentry into the United States at will.²⁶ Moreover, the substantial exclusion under section 911 for income earned while working abroad,²⁷ and the fact that in most cases nonresident citizens will claim larger foreign tax credits than those who reside here, provide a measure of compensation to U.S. citizens living abroad for any reduction in services they receive from the U.S. government.

When the United States taxes its non-resident citizens, it naturally increases the number of cases in which the world-wide income of an individual is taxed twice. As long as the United States continues to allow a foreign tax credit, limited only to the U.S. tax on the taxpayer's overall income,²⁸ however, duplicative taxation can be eliminated in many cases. Since the tax imposed by the foreign country of residence on income from third countries, as well as income derived within its borders, can be credited against U.S. tax liability, the only significant problems arise from taxation of U.S.-source income by the foreign country of residence.²⁹ In such cases, given the general international recognition of residence as the primary basis for the taxation of world-wide income, the United States should in fairness assure a full credit for the foreign tax imposed.³⁰ This result can be achieved, however, without foregoing U.S. citizenship as a basis for general taxation of world-wide income.

Resident and Non-Resident Aliens. An alien who is a resident of the United States is taxed on world-wide income in substantially the same

26. *Worthy v. United States*, 328 F.2d 386, 394 (5th Cir. 1964).

27. For 1984, the exclusion is \$80,000. I.R.C. § 911(b)(2)(A).

28. Under I.R.C. § 904(a), the total amount of the foreign tax credit "shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States . . . bears to his entire taxable income for the same taxable year."

29. Lazerow, *Business Impact of the United States—France Income Tax Protocol*, 19 SAN DIEGO L. REV. 341, 343-48 (1982). The United States and France recently signed a revised protocol to reduce the scope of this problem. See DAILY TAX REP. (BNA), No. 30, at G-1, J-1 (Feb. 14, 1984).

30. This policy would require amendment of I.R.C. § 904(a). See *supra* note 28.

manner as a U.S. citizen.³¹ There is no doubt that this principle of taxation is fair and in accordance with internationally accepted standards. If reasonably applied, a residence rule reflects a real life connection to the United States and an exercise of choice by the affected individual, that is, coming to live in the United States. Since this principle is practically certain to remain part of our system, the question is not whether to adopt the principle itself but rather how to determine residence status and, depending upon the resolution of that issue, whether to adopt collateral rules to assure that harsh or distortive consequences do not flow from a finding of U.S. residence.

The Historical Test: "All the Facts and Circumstances". Historically, residence in the United States for federal income tax purposes was determined on the basis of a generalized "all of the facts and circumstances" test, which is founded largely on common law concepts. Although the statute set forth no definition, the regulations stated that if an alien "lives in the United States and has no definite intention as to his stay, he is a resident."³² Under this standard, as further delineated in the extensive case law on the subject, the finding of residence depends on a combination of physical presence and intention to remain in the United States.³³

Residence proved, however, to be an "elusive concept."³⁴ Despite the fact that the IRS presumed an alien to be resident in the United States if the alien is continuously present for a period of one year or more,³⁵ the evidentiary problems raised by the need to prove an individual's intentions placed a severe administrative burden on the IRS and made it difficult for tax practitioners to give their clients clear advice. In addition, as the *Brittingham* case demonstrated so well,³⁶ the practical effect of the generalized test was to allow some aliens to live in the United States for extended periods of time without being deemed to be residents.

In principle, the determination of residence on a case-by-case basis could redound with equal frequency to the advantage of the IRS or to taxpayers, depending on the particular situation. While there seems to be no statistical evidence, the general perception was, however, that individual taxpayers were given the benefit of the doubt and that the cost of uncertainty fell largely on the government.

B. *The New Objective Test*

The Deficit Reduction Act of 1984 (hereinafter the 1984 Act) estab-

31. Treas. Reg. § 1.871-1(a) (1957), as amended by T.D. 7332 (1974), T.D. 7670 (1980).

32. Treas. Reg. § 1.871-2(b) (1957).

33. See, e.g., *Park v. Commissioner*, 79 T.C. 252 (1982); *Marsh v. Commissioner*, 68 T.C. 68 (1977); *Friedman v. Commissioner*, 37 T.C. 539 (1961).

34. *Brittingham*, 66 T.C. at 412.

35. Rev. Rul. 69-611, 1969-2 C.B. 150.

36. See *supra* note 17.

lishes an objective statutory test of residence.³⁷ The new legislation is designed to substitute a series of more mechanical tests for the generalized "intention" test that previously existed. The catalyst for the new legislation was a 1982 recommendation by the ABA Section of Taxation.³⁸ Under the enacted version of the bill, three tests are established; an alien meeting any one of them is deemed to be a resident for income tax purposes.

Under the first test, an alien who has acquired the status of permanent resident under the immigration laws is deemed to be a resident for tax purposes from the first time he is physically present in the United States.³⁹ Under the second test, an alien is deemed to be a resident if physically present in the United States for at least 183 days in the taxable year, with exceptions for personnel of foreign governments and international organizations, teachers, trainees, students, and those medically unable to leave the country.⁴⁰

If neither of these tests is met, the alien nevertheless will be presumed to be a resident if he is physically present: (i) for at least 31 days in the current taxable year; and (ii) for at least 183 days during the current and the preceding two years, counting each day in the preceding year as 1/3 of a day and each day in the second preceding year as 1/6 of a day.⁴¹ The effect is, for example, that an alien present in the United States for at least 122 days in every year would be presumed to be a resident in all years. The exceptions for employees of foreign governments and international organizations, teachers, trainees, students, and those medically unable to leave the country apply here also. In addition, the presumptive determination of residence will be overcome for a particular year if the alien established that he or she: (1) has a "tax home" in a foreign country;⁴² (2) has a closer connection to such foreign country than to the United States;⁴³ and (3) has not applied for or taken other steps looking toward the acquisition of permanent resident status under the immigration laws.⁴⁴

Under the so-called "non-lapse" rules, if an individual who is a resident at any time in one year becomes a resident at any time in the next year, resident status continues in the intervening period. Moreover, if an individual, having been a resident for three consecutive years, again becomes a resident within the three succeeding years, any U.S.-related income (but not

37. See I.R.C. § 7701(b).

38. See 1982 RECOMMENDATIONS OF THE ABA SECTION OF TAXATION at 41. The principal difference between the ABA recommendation and the legislation as adopted is that the ABA required that an alien be present in the United States for 183 days in the current year in order to establish residence, without resort to a three-year look-back.

39. I.R.C. § 7701(b)(1)(A)(i).

40. *Id.* § 7701(b)(3)(A), (D).

41. *Id.* § 7701(b)(3)(A).

42. *Id.* § 7701(b)(3)(B). "Tax home" is used in I.R.C. §§ 911(d) & 162(d) to identify an individual's regular place of abode.

43. *Id.* § 7701(b)(3)(B).

44. *Id.* § 7701(b)(3)(C).

foreign income) derived during the interval remains taxable on an ordinary net income basis and at individual progressive rates, regardless of whether it would normally be so taxed in the hands of a non-resident alien.⁴⁵

C. Comments on the Objective Test of Residence

Whether the precise tests set forth in the 1984 Act represent the proper rules for determining U.S. residence depends, among other things, on how assertive the United States wishes to be as a matter of policy. Obviously, tougher residence rules may deter the free flow of individuals to the United States, but they also will assure the payment of a full tax by those availing themselves of substantial benefits of the government or its laws. It seems fair to say that the rules adopted by the 1984 legislation are assertive, in the sense that they go beyond the kinds of rules which are applied by most countries of the world. For example, there does not appear to be any other country which asserts world-wide taxing jurisdiction on the basis simply of an individual's legal right to become resident under the immigration laws; yet, under the legislative definition, a person holding a U.S. "green card" will be considered a resident if he sets foot in the U.S. for just one day, or, indeed, if he never sets foot in the U.S. but holds a "green card" throughout the year 1984.⁴⁶

The fundamental idea of substituting an objective test of residence for the vague subjective test which now applies seems commendable and in keeping with internationally acceptable standards. To take only one example, Canada has found it expedient to treat a person as a Canadian resident if that person is present in the jurisdiction for 183 days in the taxable year.⁴⁷ It may be worthwhile, however, to consider some of the consequences that shifting to an objective test of residence will or may have.

First, the 1984 Act may cause more frequent changes in the status of many aliens who do not seek or have immigrant status. A major purpose of the provision seems to be to accelerate substantially the point at which residence will be established. The provision will also accelerate the opposite change of status, from resident to non-resident, permitting aliens to avoid taxation of foreign-source income in chosen years. Just as an objective test provides a bright-line for *including* aliens as taxpayers, such a test also provides a safe-harbor for taxpayers seeking to *avoid* domestic status.

Under the 1984 Act, a non-immigrating alien who wishes non-residence tax status for a year must merely be sure to be present in the United States for 30 days or less during that year. The next year, of course, he may come back and may again be treated as a resident, without affecting the prior year. (Under the non-lapse rules, the period between two resident peri-

45. See I.R.C. § 7701(b)(9).

46. See Pub. L. 98-369 § 138(b)(2) & (3).

47. Canadian Income Tax Act § 250(1)(a), 34 CANADIAN TAX REPORTER (CCH) ¶ 26,128 (1983).

ods is counted as a period of residence only if those periods fall in consecutive taxable years, and the special rules relating to the taxation of U.S.-source income apply only after a period of three consecutive years of residence.⁴⁸ Thus, to the extent that the recognition of income can be timed, non-immigrating aliens might develop a "rhythm" method for minimizing United States tax on foreign-source income and such U.S.-source income as gains from the disposition of personal property investments. Admittedly, this problem arises only in the case of the non-immigrating alien, but this class of cases seems to be a substantial part of the problem to which the legislation is directed.

Problems of Dual Residence. The United States may consider an alien to be a resident for income tax purposes even though he is simultaneously so considered by another country. This problem also existed under the prior law. To the extent that the proposed objective test tightens the residence definition, however, it may increase the number of instances in which this duality actually occurs. Many such dual residence cases will be dealt with by the United States' income tax treaties, which are not overridden by the new legislation.⁴⁹ Moreover, many of the newer treaties contain a provision similar to article 4 of the OECD Model Double Taxation Convention,⁵⁰ which is designed to prevent double taxation when both of the Contracting States consider an individual to be a resident taxpayer under their internal laws. This "tie-breaker" provision looks first to the jurisdiction in which the person has a permanent home "available", and if one is available in both jurisdictions, then to the country in which the person has his "center of vital interests." If these factors are not decisive or cannot be determined, then the provision looks to the jurisdiction in which the individual has his "habitual abode".⁵¹

These provisions, as can be seen, operate on the basis of criteria wholly different from those utilized in the proposed legislative definition. Legal immigrant status is not relevant. The length of time present in the jurisdiction is not relevant, except to the unspecified extent that it may contribute to the identification of an "habitual abode". Only in the third level test under the 1984 Act, where the United States' definition of residence depends on whether the individual has a "tax home" in and a "closer connection" to another foreign country, do the factors set forth in the tax treaties seem to come into play.⁵²

48. See I.R.C. § 7701(b)(9).

49. H.R. REP. NO. 432, 98th Cong., 1st Sess. 223, 227 (1983).

50. See OECD Model Double Taxation Convention on Income and on Capital, 1 TAX TREATIES (CCH) ¶ 171 (1980) [hereinafter cited as OECD Model Double Taxation Convention]; U.S. Model Income Tax Treaty, 1 TAX TREATIES (CCH) ¶ 158 (1981).

51. OECD Model Double Taxation Convention, *supra* note 50, art. 4(2); U.S. Model Income Tax Treaty, *supra* note 50, art. 4(2).

52. See *supra* text accompanying notes 37-44.

It seems inevitable that a substantial number of cases will arise in which persons considered resident by the United States under the proposed statutory definition will also be considered by treaty partners to be resident in their countries. It seems inevitable, as well, that the "tie-breaker" articles will result in many of these people being found to be residents of the foreign treaty partner, rather than the United States. To this substantial extent, the new statutory definition will not remove the detriments of the "all of the facts and circumstances" test but will merely shift the focus of the determination to the particular, although still vague, factors referred to in the treaty articles.

The Issue of Collateral Consequences. Since the new legislative definition of residence was proposed, a variety of critics have expressed concern about the collateral consequences of determining residence under the new tests. It is one thing to use the tests embodied in the bill for the purpose of taxing in a given year the world-wide income of an individual. It is quite another thing to use the the same definitions to subject the alien himself to various anti-abuse regimes of U.S. law, as, for example, by: a) taxing the alien himself on his share of the income of a foreign personal holding company or a controlled foreign corporation, or by considering him the U.S. grantor of a foreign trust; or b) making others taxable by considering the alien a U.S. person in determining the requisite U.S. ownership. While these same effects would flow from a change of residence under the prior law, the critical outcry seems to be prompted by the fact that under the new legislation they would happen much more readily.

Underlying the concern about collateral consequences is a more fundamental question: do we really feel that a person who is defined as a U.S. resident under the new tests is a resident? The basic problem seems to be that the critics regard the new rules not as true "residence" rules, but as a kind of anti-abuse, "anticipatory" residence, or "quasi-citizenship" rule. The change from existing law is so dramatic that one can sympathize with this concern, and perhaps some transitional relief is justified.⁵³ The use of the new tests to impose full residence requirements would not be unprecedented, however. To use the Canadian example again, the 183-day "constructive resident" is considered under the Canadian Income Tax Act as a resident for all purposes, including the regime taxing Canadian shareholders on the foreign-accrual property income of foreign affiliates.⁵⁴

53. One case in which special consideration may be particularly appropriate is section 679, which taxes an individual until death on the income of a foreign trust if he is a U.S. resident during the year of its creation; this permanent effect is much further-reaching than the income tax effects that are determined on an annual basis. The vagaries of section 679 are discussed in N.Y. State Bar Association, Tax Section, *Report on Foreign Trusts*, 31 TAX L. REV. 265 (1976).

54. Canadian Income Tax Act, *supra* note 47, at §§ 91(1), 95(1)(c). This tax is payable by every "taxpayer resident in Canada." Under § 250(1)(a), any person who sojourns in Canada for 183 days in a calendar year is deemed to be resident in Canada throughout a taxation year.

All of the foregoing effects may be mitigated by the application of the "tie-breaker" provisions of the income tax treaties. An interesting question, however, is whether an alien who is a statutory resident of the United States, but is treated as a resident of a foreign country by reason of a treaty "tie-breaker" provision, is to be counted as a U.S. person for the purposes of determining the taxation of persons other than the individual himself. The question could arise, for example, in determining the source of an interest or alimony payment made by the alien or in determining whether a corporation is a personal holding company, a foreign personal holding company, or a controlled foreign corporation. In many of the tax treaties, the introductory article limits the application of the treaty to persons who are residents of one or both of the Contracting States.⁵⁵ This limitation would appear to bar the use of the tie-breaker provisions to treat an item of income as foreign-source in the hands of an individual or corporation resident in a third country. It would, moreover, apparently preclude use of the treaty by a non-resident U.S. citizen to treat the ownership of the entity as foreign for purposes of relevant corporate ownership tests. The Conference Committee's statement that U.S. law would continue to apply when not inconsistent with treaty obligations does not, however, preclude the possibility that one U.S. resident is entitled to assert the treaty status of another.⁵⁶

It can be argued that other taxpayers should be entitled to claim the treaty result in order to avoid "inadvertent and inequitable" consequences.⁵⁷ At least two theories would support such a result. First, the treaty result should be available to other taxpayers on a kind of "best evidence" theory. Although, in the absence of a treaty, a finding of residence or non-residence under internal law may be the only finding available, application of a treaty tie-breaker carries the analysis one step further and provides the "best evidence" of whether a taxpayer truly is a resident. Second, the fact that these tie-breaker articles are negotiated in tax treaties is clear evidence that inconsistent determinations of residence are disfavored. Where application of a tie-breaker mandates that a taxpayer be treated as a non-resident for taxes on his own income, then consistency is achieved only by treating him as a non-resident in determining the taxes of others as well.

There is, of course, another side to this argument. For example, A, an alien, owns fifty-one percent of French corporation C. The remaining shares of C are owned by B, an American citizen. Suppose that A spends a substantial period of time in the United States and meets the criteria for becoming a U.S. resident. In addition, he satisfies the criteria for residence

55. See, e.g., OECD Model Double Taxation Convention, *supra* note 50, art. 1; U.S. Model Income Tax Treaty, *supra* note 50, art. 1, para. 1.

56. H. R. REP. NO. 98-861, 98th Cong., 2d Sess. 967 (1984).

57. New York State Bar Association Tax Section, Committee on U.S. Activities of Foreign Taxpayers, *Report on the Definition of Resident in Section 451 of the Tax Reform Bill of 1983 (H.R. 4170)*, reprinted in 21 TAX NOTES 1317, 1324 (1984).

in Canada. If B is given the benefit of A's rights under a tax treaty, then the tax status of B (and of C) will turn on whether the United States or Canada prevails in a tie-breaker involving A. This is true notwithstanding the fact that: (1) resolution of the tie-breaker is solely within the control of A; and (2) in each instance, viewed from the perspective of the United States, B has shared ownership of a French corporation with another person who satisfies the criteria for U.S. residency. If B is seeking the benefits available to those investing in a foreign corporation, there is no inherent unfairness in requiring him to satisfy the standards for residency (and non-residency) set by internal law. It can be argued that it should not matter whether: (1) A has closer ties to Canada, so that Canada would win a tie-breaker; or (2) A, with no greater links to the United States than in (1), is such a citizen of the world that the United States would win a tie-breaker against any other single country. It is not clear how this question will be answered, although the I.R.S. has a history of interpreting treaty commitments as narrowly as it deems possible.⁵⁸

Two further issues should be noted. First, if B is entitled to the benefit of A's status under the tie-breaker, should B be *required* to accept that result, or can B treat A as a U.S. resident even though A is found to be a non-resident under the tie-breaker? The NYSBA report suggested that B "may" take advantage of the tie-breaker. This fence-sitting, which gives B the best of both worlds, seems wholly unjustified.

Second, if B is entitled to the benefit of A's treaty status, is he entitled to initiate an adjudication establishing A's status, or is he only entitled to rely on an adjudication procured by A? As a practical matter, a contest involving A's status will heavily involve the participation of A even if he is indifferent to the outcome, and there is no equitable justification for forcing A to have his status adjudicated if A himself prefers to be considered a U.S. resident. Since the primary interest is A's, it seems wise to leave him as the sole qualified contestant.

In sum, the question of the effect of the "tie-breaker" treaty provisions on other taxpayers seems sufficiently unclear to warrant an explicit legislative answer. If the "tie-breaker" determinations are to be given effect for all tax purposes, a provision analogous to section 894(b) of the Code should be added to the legislation.⁵⁹

58. Cf. Rev. Rul 79-152, 1979-1 C.B. 237 (U.S. can tax ex-citizen under section 877 even though ex-citizen is no longer a U.S. resident and the income tax treaty with the country where the ex-citizen resides does not expressly reserve to the U.S. the right to tax).

59. I.R.C. § 894(b) of the I.R.C. states, in pertinent part:

For purposes of applying any exemption from, or reduction of, any tax provided by any treaty to which the United States is a party with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. . . .

II

DETERMINING THE STATUS OF LEGAL ENTITIES

A. The Existing Law

Corporations and Partnerships. Under the Internal Revenue Code, a corporation or partnership is domestic if it is "created or organized in the United States or under the law of the United States or of any state."⁶⁰ Thus, a corporation organized under the laws of Delaware or Pennsylvania or any other state is a domestic corporation, as is a national bank organized under federal laws; the District of Columbia is treated as a state for this purpose.⁶¹ This test is generally referred to as the "place of incorporation" test,⁶² and it is to that extent straightforward.

Beyond the facial simplicity of the test, however, lies a rather surprising amount of ambiguity. The literal language of the statute includes an entity created or organized "in the United States," although not necessarily created or organized under American law. The effect of this language is not entirely clear.

The Revenue Act of 1918 referred only to entities created or organized "in the United States."⁶³ In 1920, the Bureau of Internal Revenue published O.D. 661,⁶⁴ which dealt with an organization whose articles of incorporation were filed with the clerk of the United States Court for China—presumably located in China—under the asserted authority of an Act of Congress. "[G]athering the legislative intent from the [Revenue] Act as a whole," the Bureau stated:

It is fundamental that a corporation is a creature of the law and can exist only by virtue of the law which creates it. Such a corporation must of necessity be domestic to the country under whose laws it is created. . . . It is difficult to conceive any other case than the one in hand in which a corporation can claim to be organized under the laws of the United States and at the same time be not organized *in* the United States. . . . [T]he expression 'created or organized in the United States' will be construed to include corporations created or organized under the laws of the United States. The phrase 'in the United States' is believed to have been used in the two sentences defining domestic and foreign corporations chiefly for the purpose of providing for those associations which are not organized under any incorporation laws

60. I.R.C. § 7701(a)(4).

61. I.R.C. § 7701(a)(10).

62. The importance of the "place of incorporation" test under American law is demonstrated by the U.S. reservation to article 4(3) of the OECD Model Double Taxation Convention, *supra* note 50. The model convention states that if a taxpayer, other than an individual, is considered a resident of both Contracting States, then the taxpayer shall be deemed to be a resident of the State in which its place of effective management is situated. The United States (and Canada) reserved on this point so that they may assert the right to use the place of incorporation as the test for residency for companies. See REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS at 58 (1977).

63. Pub. L. No. 65-254, § 1, 40 Stat. 1085 (1919).

64. O.D. 661, 3 C.B. 19 (1920).

but by private contract and yet fall within the definition of corporations as used in the Revenue Act.⁶⁵

Without reference to O.D. 661 or other meaningful legislative history, the Revenue Act of 1924 added the "under the law of" language which is now codified in section 7701(a)(4) of the Code.⁶⁶

This history confirms the plain statutory reading that a corporation organized under the laws of the United States is a domestic corporation. It also suggests, though less clearly, that a corporation is to be deemed "organized in" the place where its articles of incorporation are filed or its charter is granted. In most cases, of course, these questions are moot, since the entity will be found to have been organized both within and under the laws of the United States or without the United States and under the laws of a foreign country. Certainly in practice, there is no suggestion that anything other than the place of incorporation is relevant in determining the status of a corporation.

The situation with respect to non-corporate entities, such as partnerships and unincorporated associations, may not be so clear, however. The Anglo-American concept is that a corporation derives its juridical being from the grant of its charter by the State. By contrast, a partnership is deemed to derive its being from the agreement between the parties, which is, like other contracts, subject to laws governing its interpretation and performance.

It would be surprising, nevertheless, if an entity created under a state law equivalent to the Uniform Partnership Act or the Uniform Limited Partnership Act⁶⁷ were held to be foreign because the agreement was actually executed and delivered abroad.⁶⁸ The seemingly more substantial issue arises out of the fact that for tax purposes a partnership includes "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on" and which is not classified as a corporation, trust, or estate. In the case of partnerships and joint ventures which are not a formal partnership, but which are created under a formal agreement, it is usual for the parties to incorporate a choice of law clause specifying the law which governs the interpretation and performance of the contract. To say in such a case that the venture is "created or organized under the laws of" the jurisdiction chosen is, perhaps, straining the statutory language a bit, but in principle this interpretation may produce a plausible result.⁶⁹

65. *Id.* at 20.

66. Revenue Act of 1924, Pub. L. 68-176, § 2(a)(3).

67. See UNIFORM PARTNERSHIP ACT, 6 U.L.A. 1 (Supp. 1983); UNIFORM LIMITED PARTNERSHIP ACT, 6 U.L.A. 559 (Supp. 1983).

68. *Cf.* O.D. 661, *supra* text accompanying notes 63-65. It should also be noted that, at least in the case of a limited partnership, it is the filing of the agreement under state law which confers limited liability on the limited partners.

69. A choice of law clause in an agreement may waive an otherwise valid claim of sovereign immunity. See H.R. REP. NO. 1487, 94th Cong., 2d Sess. 18, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 6604, 6617 (discussing 28 U.S.C. § 1605(a)(1) (1976)). If such a clause can

Parties to international transactions often use a variety of informal arrangements, however, which specify no governing law and, indeed, which might involve substantial conflict of laws issues.⁷⁰ Pressed for a resolution under these circumstances, one might be tempted to discard the "under the laws of" language and determine the residence status of the entity by reference to the "created or organized in" test. This test, however, fails to produce substantially better results. If the reference is to the steps taken which result in the creation of the legal relationship involved, what does one do with a case in which that process occurred through the transmission of a telex from Paris to New York and the return of a confirming one? Is this a matter of contract law? If so, whose? Does it matter that an offer was telexed from Paris and accepted in New York, rather than telexed from New York and accepted in Paris? Quite apart from these procedural questions, the particular place where or process by which an informal joint venture is formed seems a highly arbitrary basis on which to rest possibly important tax consequences.

It is possible that the phrase "created or organized in" is not meant to refer at all to the process by which the legal relationship was formed but to the physical location in which the operations of the venture are commenced. This interpretation of the phrase would lead to immediate chaos, however, since operations may be commenced and carried on at several locations, either simultaneously or sequentially. In addition, as in the case of many financial transactions, it may be difficult to specify the actual location at which various operations occur.

Trusts. Generally speaking, trusts are treated under the Internal Revenue Code as taxable entities. The income of a grantor trust is, of course, taxed directly to the grantor, as if the trust did not exist, and in such a case the domestic or foreign status of the grantor determines the taxation of the trust's income.⁷¹ A non-grantor trust, however, remains taxable on accumulated income,⁷² and must be classified as a foreign or domestic taxpayer for this purpose. In addition, the classification of a trust is relevant for purposes of determining the ownership of foreign entities and for other important income tax purposes.⁷³

waive immunity to suit, then it may also waive a claim that one is "foreign". Agreement to a choice of law clause evidences an affirmative desire to avail oneself of the benefits of the jurisdiction selected, in the form of a settled legal order.

70. See, e.g., *Johnston v. Commissioner*, 24 T.C. 920 (1955) (citizen of Canada made oral agreement forming second-tier partnership between Canadian partnership of which he was a member and a United States partnership; Canadian members of partnership performed services in Canada, while U.S. members of partnership performed services in U.S.).

71. See I.R.C. §§ 61(a)(15), 671-679; Rev. Rul. 69-70, 1969-1 C.B. 182.

72. I.R.C. § 641(a)(1), (4).

73. I.R.C. §§ 7701(a)(30)(D), 7701(a)(31). A trust, other than a foreign trust, is a U.S. person under section 7701(a)(30)(D); the definition of U.S. person under this section is integral

Unfortunately, the basis for determining the domestic or foreign status of a trust is vague at best. In fact, the Code completely ducks the issue by defining a foreign trust, with unabashed circularity, as one which is taxable only upon its U.S.-related income.⁷⁴ The Regulations ignore the question entirely.⁷⁵ What little precedent exists seems to proceed by analogizing a trust to an individual. The reason for this analogy is unclear, unless it proceeds from a naively uncritical extension of the injunction in section 641(b) that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual"⁷⁶ Nevertheless, to the extent that the fragments of precedent can be pieced together at all, the characterization of a trust which is created in a foreign country or under foreign law seems to revolve around the question of whether the trust itself is a "non-resident alien".⁷⁷

The residence of a trust depends upon the facts and circumstances of each case,⁷⁸ but some factors influencing the decision have been identified. The citizenship and residence of both the grantor and the beneficiaries are irrelevant.⁷⁹ Factors which are to be considered include the nature of the trust assets,⁸⁰ the residence and nationality of the trustee or trustees,⁸¹ and the place used for the principal administration of the trust's affairs.⁸²

to the definition of, *e.g.*, U.S. shareholders for purposes of defining controlled foreign corporations. *See* I.R.C. §§ 951(b), 957(a), (d).

A grantor trust with a non-resident alien grantor would not be a U.S. person, regardless of how or where the trust was formed, because trust income from a source without the United States and not effectively connected with the conduct of a trade or business within the United States is not taxed. I.R.C. § 7701(a)(31) (defining "foreign trust"). *See* I.R.C. §§ 61(a)(15), 671-679; Rev. Rul. 69-70, *supra* note 71.

74. I.R.C. § 7701(a)(31).

75. Treas. Reg. § 301.7701-4 (1960) discusses trusts, but does not mention foreign trusts. Treas. Reg. § 301.7701-5 (1960) discusses foreign partnerships and corporations, but not foreign trusts.

76. I.R.C. § 641(b). *See also* I.R.C. § 642.

77. *See, e.g.*, B.W. Jones Trust, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943). *Cf.* Maximov v. United States, 373 U.S. 49 (1963), *aff'g* 299 F.2d 565 (2d Cir. 1962) (trust is "American" where it was created under the laws of Connecticut even though it was created by person who was a resident and citizen of the United Kingdom and beneficiaries were English).

For a thorough, if somewhat outdated, discussion of foreign trusts (and foreign estates), *see* S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS II-47 to II-68 (1968).

78. *See* S. ROBERTS & W. WARREN, *supra* note 77, at II-51; Alexander, *Controlled Foreign Corporations and Constructive Ownership*, 18 TAX L. REV. 531, 540-41 (1963); *cf.* Rev. Rul. 62-154, 1962-2 C.B. 148, 150.

79. *See* Maximov v. United States, 373 U.S. 49 (1963); B.W. Jones Trust, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943); S. ROBERTS & W. WARREN, *supra* note 77, at II-5 (discussing cases).

80. Rev. Rul. 62-154, 1962-2 C.B. 148; S. ROBERTS & W. WARREN, *supra* note 77, at II-5A(2). There may be conceptual problems in determining the situs of assets when the assets are, for instance, shares of stock. Query which is relevant, the location of the stock certificates or the location of the corporation?

81. S. ROBERTS & W. WARREN, *supra* note 77, at II-5A(2).

82. Alexander, *supra* note 78, at 540-41.

Clearly, consideration of the foregoing factors does not give rise to clear results in a broad range of cases. As most trust grantors tend to be wealthy, and therefore well advised, they may undoubtedly marshal the relevant factors into a pattern that is either decisively domestic or decisively foreign, according to their interests. Nevertheless, the existing situation gives rise at least to a feeling of disquiet. While the well-advised may plan around the problem, those who fail to seek or heed advice, or who find themselves at the mercy of family circumstances, may create situations which are difficult to categorize using the existing criteria.

For example, in one situation familiar to the author, a testamentary trust was created for a life beneficiary with the remainder interest to the grantor's three grandchildren. The trust was created under an American will, and was therefore governed by the law of an American state. The trust named two individuals as trustees, one a citizen and resident of the United States and one a national and resident of Belgium. The Belgian trustee was to manage the investment of trust assets, which consisted largely, though not exclusively, of U.S. securities, through an account maintained in the Brussels office of Merrill Lynch. The U.S. trustee was to determine the needs of the beneficiary and, because the trustees had discretion in the matter, to decide how much of the income, and, if necessary, the corpus to distribute to the beneficiary.

The initial reaction to this case is that the trust is a domestic trust because its American contacts exceed those abroad. Further analysis of the situation reveals that the characterization is not so clear. The U.S. status of the grantor and the beneficiaries are said not to be relevant, and weighing the status of the trustees produces a draw. The principal place of administration is either abroad or in the U.S., depending upon whether it is the investment policy or the distribution policy which constitutes administration. The fact that the trust assets are largely invested in U.S. securities may help to determine the residence of the trust under the "nature of assets" test.⁸³ It is also possible that the trust could be considered a U.S. citizen because it was created under U.S. law⁸⁴ and therefore be incapable of achieving non-resident alien status.⁸⁵

Even if the trust were conceded to be a U.S. person, its status would remain uncertain if it were governed by foreign law or its corpus were invested entirely in foreign securities. Further uncertainties could arise if, as once threatened, the U.S. trustee resigned, leaving the Belgian as the sole trustee.

83. For this purpose it may be important to determine whether the assets will be treated as "ownership interests in U.S. corporations" or "securities located and managed in Belgium."

84. Compare *Maximov v. United States*, 373 U.S. 49 (1963), discussed *supra* in note 77.

85. Note that the grantor could avoid this problem by allowing the trustees to select another governing law, as many trusts now do. If the trustees select another governing law, however, the trust may be taxable for a ten-year period under section 877 of the I.R.C. as having lost its U.S. "citizenship" for tax avoidance purposes.

It is hardly profitable to discuss all of the changes which could be woven about this central theme. The few permutations discussed above are enough to demonstrate that the state of the law is far too uncertain in view of the fundamental tax effects which flow from the finding that a trust is domestic or foreign.⁸⁶

Estates. The statutory and regulatory framework for determining the domestic or foreign character of an estate is the same as in the case of a trust, that is, no framework at all.⁸⁷ The principal difference in treatment lies in the fact that, in the case of a trust, purportedly no weight is attached to the citizenship or residence of the grantor, while in the case of an estate, substantial weight appears to be attached to the status of the decedent. In a 1964 revenue ruling, the IRS stated:

The estate is merely the representative of the decedent after death and, in the ordinary case, the same tax consequences should occur whether the decedent collects the income before his death or his estate collects it after his death.⁸⁸

On the other hand, the IRS has held that alimony payments made by the U.S. ancillary administrator of the estate of a non-resident U.S. citizen constituted foreign-source income.⁸⁹ The ruling leaves unanswered the question of whether the IRS assumed without analysis that the estate of the non-resident was a foreign estate, or determined this fact after weighing the factors involved. Those who have interpreted the IRS's ruling as holding that the estate of a non-resident U.S. citizen is automatically a foreign estate have used this result as an estate planning tool in more than one case. If a U.S. citizen's testamentary beneficiaries are also U.S. persons, the interposition of a foreign estate provides a window of time between the imposition of tax on the decedent and the imposition on the ultimate beneficiaries in which to utilize the equivalent of a foreign accumulation trust. Section 679 of the Code does not apply.⁹⁰ If there is income in respect of the decedent which arises from foreign sources, this income may be realized free of U.S. tax prior to distribution to the beneficiaries.⁹¹

86. The rules currently applicable to trusts are not unlike the "all-the-facts-and-circumstances" test, which, until recently, was applied to determine whether an individual is a resident or non-resident. The unsatisfactory nature of that test, of course, was the catalyst for the recent legislative changes providing an objective test for the residency of individuals.

87. Foreign trusts and foreign estates are discussed in the same section of the Code, § 7701(a)(31), and ignored in the same section of the Regulations, Treas. Reg. § 301.7701-5. See *supra* note 75.

88. Rev. Rul. 64-307, 1964-2 C.B. 163, 165.

89. Rev. Rul. 69-108, 1969-1 C.B. 192.

90. I.R.C. § 679(a)(2)(A) exempts transfers of property that occur "by reason of the death of the transferor."

91. Such income would be income to a nonresident (the estate) and, by hypothesis, not effectively connected with the conduct of a trade or business within the United States. Thus, under section 872(a), the income would not be taxable to the estate. See also I.R.C. § 691(a)(3) (income in respect of decedent accorded same source as would apply to income received by decedent).

If the decedent owns assets in more than one jurisdiction, an ancillary administration in the non-domiciliary jurisdiction may be required. While ancillary administration involves a separate fiduciary and a separate court proceeding, the IRS views the estate nevertheless as a unitary entity, either domestic or foreign in its entirety.⁹² Thus, the IRS has held that a U.S. citizen who transferred property under two wills, one a U.S. will disposing of U.S. assets and one a foreign will disposing of foreign assets, created only a single estate.⁹³ Although there appears to be no precedent, presumably the unitary principle similarly applies when the primary administration is abroad and the ancillary administration is in the United States.⁹⁴

Certain situations other than the death of an individual result in the creation of a legal entity treated as an estate for income tax purposes. These situations include the appointment of a committee for an incompetent⁹⁵ and the bankruptcy of an individual.⁹⁶ In both cases, the appointed fiduciary must compute and pay tax in generally the same manner as for a decedent's estate, and, absent any suggestion to the contrary, the domestic or foreign character of such an entity would appear to be determined under the rules relating to trusts and estates generally.

In the bankruptcy case, however, the principal effect of the determination as to whether the bankrupt individual's estate is domestic or foreign may be to determine whether the interest it pays to creditors has a U.S. source or a foreign source.⁹⁷ The question therefore arises as to whether the status of a bankrupt's estate is "frozen" by his status at the date of filing, just as the status of a decedent's estate is determined by the decedent's status at death, or whether later changes in the bankrupt's status are taken into account to alter the source of interest payments from time to time. Such questions may arise only rarely, but when they do, no basis exists for their resolution.

B. Reforming the Law

Entities are not people. One needs to recognize this fundamental difference at the outset of any search for the most acceptable rule or rules for

92. *See, e.g.*, Rev. Rul. 64-307, 1964-2 C.B.

93. *Id.* In that ruling, the estate was held to be domestic in its entirety and income from the foreign property was required to be reported on the fiduciary income tax return filed on behalf of the estate by the U.S. executor.

94. To the extent income in such a case is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, the income would be taxable under section 871.

95. *See* I.R.C. §§ 641, 6012(b)(2), 7701(a)(6); Treas. Reg. § 301.7701-6 (1960).

96. *See* I.R.C. §§ 1398, 6012(b)(4). The bankruptcy of an individual creates an estate only if the filing involves chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations). There is no estate created when an individual files under chapter 13 (adjustment of debts of an individual with a regular income). *See* I.R.C. § 1398(a). *Cf.* Rev. Rul. 72-387, 1972-2 C.B. 632.

97. *Cf.* Rev. Rul. 69-108, *supra* text accompanying note 89.

determining the domestic or foreign nature of legal entities. Both tax laws and tax lawyers tend to attach to these entities the same labels used to describe the connections between individuals and taxing jurisdictions. For instance, the English courts have struggled to analogize the "residence" of a company to that of an individual.⁹⁸ There are common threads in the two situations, but each case is different and requires separate consideration.

It is reasonable and appropriate for a country to tax a legal entity on income which originates within its borders. The question then is what kind of "ligatures", to use Ralf Dahrendorf's coinage,⁹⁹ between the entity and the country justify going beyond this simple rule to tax income of the entity which is conceded to have its source elsewhere. Each kind of entity must be considered separately, for on empirical and, perhaps, theoretical grounds there may be significant differences among them. The fact that a partnership is not a taxable entity whereas a corporation is a taxable entity may, for example, have an effect on the outcome. And the fact that an estate is intimately identified with the personal affairs of the decedent may suggest treatment different from that of a corporation, even if the corporation is owned by a single individual.

Corporations. Although the rationale for the "place of incorporation" test has seldom been articulated, the test seems to rely on the notion that a corporation is able to earn income by virtue of being a juridical entity, in that it derives its income-earning capacity from the granting of its charter. The jurisdiction granting the charter and investing the entity with the legal capacity to earn income then has the right to tax that income when it arises. Taxing a corporation based on its place of incorporation is analogous to taxing an individual on the basis of citizenship because both focus on the grant of legal status to the taxpayer by the taxing country.¹⁰⁰ Broadly stated, the policy of existing law is to allow a corporation to freely choose domestic or foreign status, including the status of an existing subsidiary, but to impose a consistency requirement. After the first free chance, a mid-life shift in a corporation's status may be achieved only at the price of "killing" the old corporation and "creating" a new one, with consequent tax effects under such recognition provisions as Code sections 367, 1491, and 1248.

The "place of incorporation" test has one distinct advantage and one serious drawback. Its advantage lies in the certainty which arises from its application. If the test is applied by reference solely to the jurisdiction in which the corporation's charter is filed and by whose laws, therefore, the relations among its shareholders are governed, there can be no doubt as to

98. See *infra* text accompanying notes 100-114.

99. R. DAHRENDORF, *LIFE CHANCES* 30-39 (1979).

100. The United States, of course, is one of the few countries where both citizenship and the place of incorporation are determinative of tax status.

what is a domestic and what is a foreign corporation.¹⁰¹ The drawback of the "place of incorporation" test is that a corporation is by nature androgynous; it can and does autonomously create progeny. In this characteristic lies the important difference between the corporation and the individual. While there are some factors which may strongly influence the decision to incorporate a business in the United States rather than abroad, it is unlikely that a business such as IBM would have been incorporated outside the United States under any circumstances. Once the decision to incorporate in the United States is made, there are tax restraints on changing the decision and re-incorporating abroad. There are far fewer restraints, however, on the ability of a U.S. corporation simply to incorporate a subsidiary abroad, thus creating another taxpayer having a different status.¹⁰²

There is little question that the place of incorporation is a crude, if not naive, criterion of domestic corporate status. The question really is whether there exists a more rational and workable alternative. Some of the alternative tests that have been devised seem workable, but they do not address the central problem of U.S.-connected entities deriving entirely foreign income. For example, the United States might provide, as is done in Pakistan, that any corporation which has more than half of its gross income for a requisite period effectively connected with the conduct of a trade or business in the United States is a U.S. corporation. Such a rule would accomplish relatively little, however, as the effectively connected income of even a foreign corporation is already taxable under the Code. Thus, any increase in taxability under U.S. laws would be only on the remaining income of the corporation.

Moreover, a change of this kind could be made effective only by overriding the provisions of existing income tax treaties. The reaction of trading partners to actions which depart this far from traditional international tax conceptions can be judged by the outcry over unitary taxation¹⁰³ and the longer-standing resentment over the United States' "extra-territorial" im-

101. Even this long-revered axiom may no longer be wholly true. Under recently enacted amendments to the Delaware Corporation Law, a foreign corporation may domesticate itself by filing its charter in Delaware. Del. Code, ch. 1, tit. 8, §§ 388, 389. At least under the first of these provisions, which relates to a permanent rather than a temporary change in the corporation's domicile, domestication will occur regardless of the effect of the filing under the foreign law governing the corporation's affairs at the time of the filing. Thus, a corporation could be considered a Delaware corporation under Delaware law while still being treated under foreign law as organized under the law of a foreign country. The problem is aggravated by the fact that the Delaware law in such a case specifies that "the existence of the corporation shall be deemed to have commenced on the date the corporation commenced its existence in the jurisdiction in which the corporation was first formed, incorporated or otherwise came into being." *Id.* § 388(d). *Quaere*: whether this means that the corporation should be deemed always to have been a U.S. corporation for any relevant federal income tax purpose?

102. See Roberts, *From the Thoughtful Tax Man*, 40 TAXES 355 (1962).

103. The protests of Japan and members of the European Community against unitary taxation have been reported almost weekly during the past year by the specialized tax newsletters. See, e.g., DAILY TAX REP. (BNA), No. 29, at G-4 (Feb. 13, 1984).

sition of the "secondary" dividend tax on certain distributions by foreign corporations.¹⁰⁴ Here the gain does not seem worth the stakes. The same is true of similar rules which base the domestic status of a corporation on the conduct of business within the jurisdiction, in combination with other factors relating to ownership and control.¹⁰⁵

The obvious and more responsive possibility would be to fashion a test under which a corporation would be considered a U.S. person on the basis of what is popularly known as its "residence". The test might be cast in any of several ways, including reference to the place of the corporation's central management and control, the place of its effective management, or the place in which its business is principally transacted.¹⁰⁶ Although the particular factors to be taken into account would vary according to the exact formulation of the test, the concept would be to identify, not the jurisdiction which gives the corporation its legal life, but rather the jurisdiction in which its economic life is centered, focusing on inputs such as the capital, technology, and management skills which give the corporation the economic ability to earn income. This jurisdiction may be easier to identify in concept than in practice, however.

England and the other Commonwealth countries provide a good example of the problems associated with the "residence" test. In these countries, the residence of a company is a matter of common law. The courts have for many years followed, or purported to follow, the landmark decision in the *de Beers* case.¹⁰⁷ *De Beers* enunciated the test that the residence of a company, while a question of fact, depends upon the location of the "central management and control" of the company.¹⁰⁸ The most important factor in determining the location of the central management and control is the location at which the company's Board of Directors meets or otherwise discharges its functions.¹⁰⁹ At least one leading case suggests that this factor is decisive¹¹⁰ and, in the broad range of cases, the law has in fact been so applied.

The English reports are littered, however, with more disturbing opinions. One case, for example, holds that an English company was resident in England although all of its Board of Directors meetings were held and its

104. See, e.g., OECD MODEL DOUBLE TAXATION CONVENTION, REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, Commentary to art. 10, ¶ 33, at 96.

105. See, e.g., Australian Income Tax Assessment Act § 6(1), 34 AUSTL. ACTS P. 147 (1936).

106. In the event that a corporation would be deemed a resident of more than one country under the domestic laws of those countries, the OECD model treaty provides that the corporation shall be deemed to be a resident of the country "in which its place of effective management is situated." OECD Model Double Taxation Convention, *supra* note 50, art. 4(3).

107. *De Beers Consol. Mines, Ltd. v. Howe*, 5 T.C. 198 (1905).

108. *Id.* at 213.

109. See, e.g., *New Zealand Shipping Co. Ltd. v. Thew*, 8 T.C. 208 (1922); *American Thread Co. v. Joyce*, 6 T.C. 163 (1913); *Goertz & Co. v. Bell*, [1904] 2 K.B. 136.

110. *Calcutta Jute Mills Co. v. Nicholson*, 1 Ex. D. 428 (1876).

entire business was carried on in Sweden.¹¹¹ Another case states that a company may be simultaneously resident in two countries because parts of its management process are carried on in each.¹¹² An opinion in this case further maintains that when a company engages in more than two businesses, each business may have a different place of management and control.¹¹³ Although the case did not specify this result, presumably this view requires either that the world-wide income of the company be taxed in full by both jurisdictions, or that the two businesses be separated and the separate income of each be taxed by the country of its domicile.¹¹⁴

This uncertain state of affairs seems highly unsatisfactory for several reasons. First, even if the place where the Board of Directors discharges its functions is held to be decisive, in the modern world this location may not be easy to determine. Many corporations rotate their Board meetings from one country to another. Directors are often of differing residence and nationality. With increasing frequency, Board actions are taken by written consent or in telephonic meetings. Directors waive their participation or give proxies to other directors. Management functions of large corporations are, moreover, often shared by the Board and its committees, which may, of course, meet at different places or by different means. Even if this process is correctly stage-managed, companies are always at risk that a different finding will be made. Under the English practice, such factual findings are made by Commissioners, who are employees of the Inland Revenue¹¹⁵ and the courts have reviewed the findings of the Commissioners with the utmost deference.¹¹⁶

Indeed, in recent years, the English Inland Revenue, apparently of the view that the "central management and control" test is too maleable, has sought a legislative definition of corporate residence based on the presence in England of a company's "principal office". Denied this legislative change, in 1983 the Inland Revenue issued a "Statement of Practice"¹¹⁷ designed to clarify the application of the existing common law test.¹¹⁸ The views expressed in it, if ultimately upheld by the courts, would move the English law far in the direction of the "principal place of business" rule. The Statement emphasizes that the place where a company's Board of Di-

111. *Swedish Central Railway Co., Ltd. v. Thompson*, 1925 A.C. 495 (H.L.).

112. *Unit Construction Co. v. Bullock*, 1960 A.C. 351 (H.L.).

113. *Id.*

114. See Tillingham, *Tax Aspects of International Transactions* § 1.2 (2d ed. 1984), 1 CAN. TAX REP. 2D (CCH) §§ 1120-26 (discussing *Union Corp., Ltd. v. C.I.R.*, [1952] 1 All E.R. 646, [1952] T.R. 69, *aff'd*, [1953] 1 All E.R. 729 (H.L.), and *Swedish Central Railway Co. v. Thompson*, 1925 A.C. 495).

115. *Id.*

116. A recent commentary concluded that in eleven disputed cases the Commissioners held for Inland Revenue in nine decisions and for the taxpayer in two; each of these decisions by the Commissioners ultimately was upheld. 1982 BRIT. TAX. REV. 1, 3 & n.8.

117. Inland Revenue, Statement of Practice, July 27, 1983.

118. *Id.*

rectors acts is not always determinative of the place where central management and control is exercised. It notes, for example, that central management and control may be exercised by a single individual, as in a case when a chairman or a managing director "exercises powers formally conferred [on the Board] by the company's Articles and the other board members are little more than cyphers . . ." ¹¹⁹

It is difficult to see why the United States should even consider adopting the central management and control test, with its attendant difficulties, if the effect is to base the tax status of a corporation on the geographical location of its Board of Directors meetings. The only results of such a change would be a mild stimulus to the economies of Canada, Bermuda, or our Caribbean neighbors, inconvenience in the taking of timely Board actions, and a not insubstantial measure of unfairness to small enterprises which would find it more difficult or expensive to keep their overseas subsidiaries "foreign". Further, if the central management and control test is not as simple as looking to the place where the Directors act, it may present a wholly different set of more difficult problems. The test is, after all, a factual analysis, carrying with it a degree of uncertainty and administrative complexity, and uncertainty in the test for corporate residence may prove even less tolerable than similar uncertainty in the individual case simply because the stakes are so large and the facts often so complex.

The U.S. might pass over the "centralized management and control" test in favor of the OECD's formula, which places residence where the "effective management" of the corporation is carried out.¹²⁰ Phrased, undoubtedly, to ignore legal formalities in favor of economic realities, the OECD test might produce clear answers in at least some straightforward cases.

For example: Bermuda Corporation X is wholly-owned by U.S. citizen and resident A. Corporation X engages in the business of purchasing and reselling petroleum and petroleum products, dealing entirely with unrelated parties. All of its everyday activities are carried on by a staff located in Hamilton, and its Board of Directors, consisting of A, his Bermuda lawyer, and his banker meets there. However, all policy decisions are made by A from his apartment in New York. In this case, there would be a wide measure of agreement that the place of effective management of Corporation X is in the United States. The test still relies on an analysis of all the facts presented, however, and even if the rule works in a simple case such as this, there will be many other cases in which the result is not so clear.

For example: publicly-held U.S. Corporation A owns all of the stock of Corporation X, incorporated in Country X, and this corporation in turn owns all of the stock of Corporation Y, incorporated in Country Y. Corporation X serves not only as a holding company but as the European man-

119. *Id.* at 2.

120. *See supra* note 106.

agement center for the group of which Corporation A is the parent. Corporation Y, which engages in the manufacture of high-technology products, has its executive office in Country Y, fully staffed with qualified personnel. However, in each of its principal functions—technical, production, finance, and administration—its top line officer reports to a regional officer who is employed by Corporation X in Country X. In turn, each such officer reports to an officer of Corporation A, located in the United States, who has responsibility for the functional area to which he is assigned.

Employees of Corporation A and Corporation X constitute the Board of Directors of Corporation X and employees of all the corporations sit on the Board of Directors of Corporation Y. Under the corporate manual of approvals used by the Corporation A group, officers of Corporation Y are authorized to make certain decisions affecting production and sales without express approval from higher authority. Certain more important decisions can be made only with the concurrence of the appropriate officers of Corporation X. Major decisions—such as major capital expenditures or changes in products produced (switches of production to or from Corporation Y)—can be made only with the concurrence of the responsible officer of Corporation A. These decisions are, however, rare, and the actual commitment of funds or other action is always taken formally on behalf of Corporation Y by its Board of Directors.

In this situation, it is difficult to say where the “effective management” of Corporation X is located. It is clear that ultimate authority rests in Corporation A. On the other hand, the decisions actually made by Corporation A are those on which even a fully independent management might seek the views of its principal shareholder. From the U.S. point of view, of course, it is immaterial whether Corporation Y may be deemed to be effectively managed by officers of Corporation X in Country X.

These ambiguities in the determination of the place of effective management could be resolved in either of two ways. First a distinction could be made between shareholder or “stewardship” activities, which are not to be considered, and management functions, which are. This approach, however, creates other problems. Considering only management functions, the corporations in the above examples would clearly be treated as foreign corporations, unless the corporations have insufficient management staff abroad. Such a deficiency can be cured simply by increasing that staff, which raises questions of fairness as between large multinationals, which can afford to employ numerous management personnel to run their foreign enterprises, and small businesses, which do not enjoy this option. The protests of the small business community against the “foreign presence” requirement of the Reagan Administration’s Foreign Sales Corporation initiative¹²¹ demonstrate the difficulties, real and political, which this kind of requirement would raise.

121. *See, e.g.*, Bus. Wk., Jan. 16, 1984, at 86–87. The Foreign Sale Corporation proposal was enacted as part of the Deficit Reduction Act of 1984.

The second way of resolving the factual ambiguities of the "place of effective management" test would be to adopt the view that, in the end, the effective management of a corporation is lodged with its controlling shareholder or shareholders, regardless of where the directors meet or the officers work. This approach would lead to a definition based on the domestic ownership of a controlling stock interest in an otherwise foreign corporation. Such a "back-door" termination of the deferral of taxation on foreign subsidiary earnings is no more likely to succeed than more direct approaches, however. The policy trade-offs between capital import and capital export neutrality have given us Subpart F in its present form, and it is unreasonable to suppose that that compromise will be upset by toying with the Code's definitional structure.¹²² Moreover, even advocates of ending deferral may have serious reservations about taxing that portion of the foreign earnings of a less-than-wholly-owned controlled foreign corporation which accrues to the benefit of foreign shareholders.

Similar analyses could be made of the analagous tests which refer to the corporation's principal place of business. These tests either stumble in the face of factual ambiguity or resolve the ambiguities by resorting to tests which favor those (mainly large) companies which have a relatively high degree of flexibility in arranging the corporate pieces of the enterprise. Further, the place of incorporation test, or some substitute, would have to be retained as an alternative, lest all U.S. subsidiaries of foreign parents be treated as foreign.

The conclusion which emerges is that domestic or foreign status will remain in effect elective over a broad range of cases under any rule which is likely to be adopted. Big companies with a range of choices concerning the deployment of personnel and access to good legal advice will normally be able to qualify for foreign status, even under standards more stringent than the place of incorporation test. An attempt to impose more stringent standards is likely to weigh particularly heavily on smaller enterprises or those which for one reason or another do not have the range of flexibility that most multinationals have. Under these circumstances, the case seems persuasive for continuing the approach of current law, making domestic or foreign status effectively elective under the place of incorporation test and utilizing Subpart F to tax through to U.S. shareholders their shares of the income of foreign corporations whose activities are not sufficiently enmeshed in the economies of foreign countries to justify, in the Congress' view, tax deferral.¹²³

122. Tillinghast, *Taxing the Multinationals: Where is the United States Headed?*, 20 HARV. INT'L L.J. 253 (1979).

123. In an attempt to "decontrol" their foreign subsidiaries, some U.S. parent corporations have resorted to, and others have at least considered, utilizing the device of a "stapled stock". Under such an arrangement, shares of a foreign corporation are usually spun off to the shareholders of the foreign corporation's U.S. parent. However, the shares of the foreign corpora-

The logic of this conclusion leads to another view so radical that it has not even been whispered for twenty years, that U.S. persons might be given the election to treat a U.S. incorporated entity as a foreign one. Experience shows that few purchasers are willing to pay full federal income tax as the price for access to the law of Delaware as governing law and prefer, if it comes to that, the laws of Canada, Bermuda, or other jurisdictions whose prices for nearly identical goods are more reasonable. The object of allowing such an election would be the rationalization of this recognized electivity, and nothing more. The proposal is senseless if an attempt is made to attach conditions to such an election that do not attach to owning a foreign corporation.¹²⁴ On the other hand, all of the effects of "foreignness", such as the application of Code sections 367 and 1248, as well as Subpart F, must flow from the election, lest unintended benefits arise.

Partnerships. Since a partnership is not a taxable entity and, as the discussion above suggests, difficult to categorize, it is tempting to conclude that it should have neither domestic nor foreign status, but rather no status at all. In other words, one might ignore the partnership altogether and refer for any relevant purpose only to its activities or the status of the individual partners. This approach appears more feasible in some contexts than in others. Under existing law, for example, interest received by another person from a partnership is determined to be U.S. or foreign source income at the partnership level; the result is wholly dependent on whether the partnership is engaged in trade or business in the United States, rather than on its domestic or foreign status.¹²⁵ A more rational source rule could be developed while still avoiding reliance on the domesticity of the partnership or

tion may not be transferred except together with the shares of the U.S. parent. While the tax consequences of such an arrangement are not beyond doubt, *see* H.R. REP. NO. 432, *supra* note 49, at 242, it seems clear that there are at least some cases in which the extent of control retained by the U.S. corporation or its management over the affairs of the foreign corporation justifies special treatment of the foreign corporation. By enacting I.R.C. § 269B, the Deficit Reduction Act of 1984 specified that foreign corporations, a majority of whose stock is "stapled" to that of a U.S. corporation, will be treated as a domestic corporation. In general, it seems inappropriate to treat a "stapled" foreign entity as a domestic one without regard to how the arrangement arose or, indeed, whether the foreign entity is in fact the clearly dominant one and therefore more naturally to be considered the "parent". A look at the actual management arrangements and the relative size of the two entities would seem justified; if the U.S. entity is the logical "parent", it would then seem appropriate to treat the foreign corporation as a controlled foreign corporation.

It must be recognized, however, that the practice of "stapled stock" clearly arose as a calculated method for avoiding the intent of the provisions relating to controlled foreign corporation. Cliff, *Pairing: A Technique for Avoiding Controlled Foreign Corporation Status and Other Burdens of U.S. Taxation*, 57 TAXES 530 (1979). The Congress obviously felt that under these circumstances a quick and clear remedy is justified, even if it is roughshod.

124. *See* Tillinghast, *Taxation of Foreign Investment: A Critique of the Boggs Bill*, 16 TAX. L. REV. 81 (1960).

125. Treas. Reg. § 1.861-2(a)(2) (1957), as amended by T.D. 6873 (1966), T.D. 7314 (1974), T.D. 7378 (1975).

the status of the partners.¹²⁶ It is debatable whether dropping the application of section 1491 to a foreign partnership would be any real loss.¹²⁷

The one place where the loss of domestic or foreign status would clearly make a substantive difference under the Code is in the computation of U.S. ownership for purposes of defining a controlled foreign corporation (or a foreign investment company). In these cases, since a domestic partnership is a U.S. person,¹²⁸ its share ownership is counted as U.S. ownership, regardless of the domestic or foreign status of the partners. The partnership's interest is counted not only for purposes of imposing U.S. tax on the corporation itself but, more importantly, for defining the degree of American voting control which justifies the imposition of U.S. tax on persons who may not, except by acting in concert, be able to command the actual receipt of the income on which they are taxed. As in the case of a source rule for interest, it would be theoretically possible to look through the partnership to ascertain the status of the individual partners. Apparently, however, it was believed, at the time that Subpart F was introduced, that the transparency approach produced the wrong answer. Although there are exceptions, in most cases a U.S. partnership acts as a unit in dealing with its investments, including voting its stock. The treatment of the partnership's interest as a unity may for this reason be appealing. To the extent, however, that the general partners of the partnership are foreign persons, their concerns will not match the concerns of other U.S. shareholders, and, when these interests predominate, the partnership's interest may in fact be more reasonably identified as a foreign one. Given these considerations, a "pass-through" rule for determining foreign corporate ownership may be the least of the many potential evils.

Assuming, however, that for this or another reason, a rule for determining the domesticity of a partnership continues to be necessary, the find-

126. For instance, Treas. Reg. § 1.861-2(a)(2), *supra* note 125, could simply be modified so that the income of a partnership engaged in trade or business in the United States is allocated (or apportioned) between its domestic activities and its foreign activities, and these allocations are then passed through to characterize the source of the interest which the partnership pays. Presumably, this could be done on either a direct (allocation) or indirect (apportionment) basis, but the same rules would apply to all partnerships.

127. See D. Tillinghast, *Much Ado About a Non-Problem—Or Is It?*, Tax Forum No. 330 at 33-35 (1974) (unpublished manuscript). I.R.C. § 1491 states:

There is hereby imposed on the transfer of property by a citizen or resident of the United States, or by a domestic corporation or partnership, or by an estate or trust which is not a foreign estate or trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign estate or trust, or to a foreign partnership, an excise tax equal to 35 percent of the excess of—

- (1) the fair market value of the property so transferred, over
- (2) the sum of—
 - (A) the adjusted basis (for determining gain) of such property in the hands of the transferor, plus
 - (B) the amount of the gain recognized to the transferor at the time of the transfer.

128. I.R.C. § 7701(a)(30)(B).

ing of a workable and sensible definition of a domestic partnership seems even more difficult than in the case of a corporation. For the reasons outlined above, the governing law may be difficult to ascertain and, in theory, less central to the character of the entity than in the corporate case. For the same reasons as discussed in connection with corporations, however, it seems prudent to continue a rule based on the governing law, at least in the case of formal partnership entities. The same elective quality inheres in both the corporate and partnership forms, and a clear, simple rule is equally desirable.

To the extent that the partnership is itself not a taxpayer, this decision holds less significance for partnerships than for corporations. It is not necessary to consider what types of income earned by a foreign partnership are to be passed through to U.S. partners; all of the income passes through. Conversely, if a partner is himself foreign, his taxable income will be computed as if he had earned it himself.¹²⁹ While the treatment of partnerships under the source rule governing interest obviously needs attention, the same would be true almost without reference to the definition which is adopted to govern the domesticity of partnerships.¹³⁰

In the case of arrangements which for tax purposes are treated as partnerships but are not formal partnership entities, reference to the agreed governing law becomes a more troublesome technique, both because the relevance of the reference is weakest and because the determination as to the applicable law may be harder to make. Even in these cases, however, the difficulties of applying other tests of domesticity are great, perhaps even greater than in the case of corporations. Parties participating in a contractual joint venture typically share in its decision-making, and thus tests based on central management and control, principal place of business, or similar criteria are likely to yield no certainty at all. Accordingly, reference to the stated or agreed governing law seems justified even here, for it gives rise to a clear choice to be made and lived with by the parties. In cases involving arrangements so informal that even a contract with a governing law clause is not available, the derivation of the governing law may be arduous; however, these extreme cases are presumably rare enough to justify applying a single basic rule, rather than trying to manufacture a series of special exceptions.

129. I.R.C. §§ 701-704. Under I.R.C. § 875(1), a non-resident alien individual is considered engaged in a trade or business within the United States if the partnership of which he is a member is so engaged.

130. There are serious questions as to whether a partnership is an entity that can claim the benefits of a tax treaty, and, if so, where the partnership should be deemed resident. See Loengard, *Tax Treaties, Partnerships and Partners: Exploration of a Relationship*, 29 TAX LAW. 31 (1975).

Trusts. A trust, though a legal entity, is not in its nature a business unit.¹³¹ A trust is typically a passive investment vehicle formed by one individual for the benefit of others. For this reason, the considerations involved in determining an appropriate rule may be different from those involved in the corporate and partnership cases. Practically speaking, however, the choices are relatively narrow.

A rule which makes the question turn on the status of the beneficiaries can be rejected out of hand as unworkable; there are simply too many trusts which have multiple beneficiaries in differing and changeable states of life and too many discretionary powers held by too many trustees. Similarly, the nature of the trust assets should not be relevant as long as the activities of the trust are sufficiently passive to avoid its characterization as a corporation or partnership. One could look to the tax status of the grantor. Indeed, for trusts which will revert in ten years and one day,¹³² this rule might be reasonable. On the other hand, many trusts have a life of their own, and to determine forever the status of a trust on the basis of the status of the (often deceased) grantor seems unduly inflexible. While a split rule for short-term and long-term trusts might thus seem appropriate, difficult problems could arise, such as those produced by section 679 or section 1491 of the Code, if the effect of the rule were to change the status of the trust from domestic to foreign during its term. If the short-term rule applied only to the 10-year trusts referred to in section 673(a), this mid-life transition would appear not to be a problem. Such a rule would, however, create only a relatively minor exception to the general rule.

With the grantor and the beneficiaries ruled out, we are left again with a choice between a rule based on governing law as stated in the trust, a rule based on some adaptation of a place of management or place of administration test, or possibly, as may be the existing law, the application of both tests at the same time.

There need be no apology for referring here to the trust's stated governing law. The definition of the rights of the beneficiaries and duties of the trustees is central to the trust concept, and, although the choice of law is originally relatively free, the legal relations of the entity assume a greater importance than its economic dynamics when its function is one of relative passivity. Moreover, as outlined above, the place of trust administration is highly elective and the residences of the trustees often inconclusive and often readily changeable. One should approach with caution any rule which would give trustees a tax incentive beyond those which may already exist for investing funds abroad, rather than in the United States.

131. The Code treats business trusts either as corporations or partnerships. See Treas. Reg. § 301.7701-4 (1960).

132. Cf. I.R.C. § 673(a) (stating general rule for grantor trusts, which includes trusts in which the grantor has a reversionary interest that can be expected to take effect within ten years).

Accordingly, just as in the case of corporations and partnerships, although perhaps for quite different reasons, it seems appropriate to make domestic or foreign status for trusts turn solely on the governing law as stated in the trust. In most cases, ascertaining the law governing a trust will not be difficult. Usually it will be specified in the instrument, and the specified choice of law will normally be upheld. If parties attempt to specify as governing law the law of a jurisdiction with which the trust, its grantor, and its beneficiaries have little or no contact, however, the attempt may not be given effect under conflict of laws principles. This result would affect the domesticity or foreignness of the trust for both tax and non-tax purposes. Although application of conflict of laws principles may introduce some complexity or uncertainty in some cases, these cases would appear to be exceptional.

Estates. A decedent's estate is a kind of "limbo" for property. Property has passed irrevocably out of the hands of the decedent and, after the period of administration, will pass to the beneficiaries.

As in the case of a trust, there are three possible ways of viewing this arrangement: first, the estate's ownership of assets could be regarded as an extension of the decedent's ownership; second, the estate assets could be regarded as instantly transferred to the beneficiaries; and third, the estate could be recognized as an independent entity. The first view would suggest determining the status of the estate by reference to the status of the decedent at the time of death, the second would suggest a reference to the status of the beneficiaries, and the third would suggest a reference to the status of the estate itself.

Of the three alternatives, the second seems impractical, as the beneficiaries may have differing statuses or unknown identities. The third, following the lead taken with respect to other legal entities, might make domestic or foreign status of the estate turn on the law which governs the obligations of the fiduciary and the rights of the beneficiaries. Thus, an estate probated under U.S. law would be a domestic estate, while an estate administered under foreign law would be foreign. In cases involving ancillary administrations, it would be necessary to make a judgment whether to split the estate into two entities, treating each according to its governing law, or to make the sometimes difficult factual decision of which jurisdiction should be regarded as the predominant one. Normally, the domiciliary jurisdiction is considered predominant, but in some estates the ancillary administration far overshadows the primary or domiciliary proceeding.¹³³

133. See *Matter of Renard*, 108 Misc. 2d 31, 437 N.Y.S.2d 860 (Sur. Ct. 1981), *aff'd mem.*, 85 A.D.2d 501, 447 N.Y.S.2d 573 (1981), *aff'd mem.*, 56 N.Y.2d 973, 439 N.E.2d 341, 453 N.Y.S.2d 625 (1982). This decision makes clear that New York, at least, will respect a direction in a decedent's will that New York law control the disposition of assets located in New York, even if other assets located elsewhere are subject to a different will or different legal restrictions. Such a result means that for some purposes, in some cases, the estate *necessarily*

The second possible "independent entity" approach would attempt to survey the facts surrounding the estate to determine its "residence", along the general lines of existing law. For the reasons set forth with respect to trusts, this approach seems unsatisfactory.

On balance, the first view, identifying the status of the estate with the status of decedent, seems preferable. In concept, the estate may properly be viewed as a form of liquidation of the decedent's affairs and its income properly considered an extension of the decedent's income stream. Although the laws under which an estate is administered have relevance to its existence, this factor seems outweighed by close attachment of the estate to the decedent and the fact that reference to his or her status makes the estate's status far less susceptible to manipulation. In addition, this view has the virtue of relative simplicity and certainty. It would result in taxation of the estates of non-resident U.S. citizens, regardless of the status of their beneficiaries. Conversely, it would not tax the estates of non-resident aliens even if all of their beneficiaries were U.S. persons. Since reference to the status of beneficiaries seems impractical in any event, no material loss of jurisdiction or revenue on this basis seems likely.

If this rule is adopted for estates, while a different rule is adopted with respect to trusts, some method will need to be established to prevent circumvention of the estate rule through the establishment of revocable trusts. In effect, a trust created during an individual's lifetime, becoming irrevocable on death, is the functional equivalent of a will. If individuals were free to select this method of transmitting their property, the estate rule would soon become ineffective. For this reason, it may be necessary to adopt a corollary rule under which the status of a trust revocable by the decedent would be treated as an estate for an arbitrary period following the decedent's death.

In the case of non-decedent estates, the rules may be kept simple and clear. In the case of a committee or guardian for an incompetent, the status of the estate's income should clearly be determined by the status of the incompetent himself.¹³⁴ In the case of the estate of a bankrupt, it seems equally clear that the status of the estate should be established by the status of the bankrupt. In bankruptcy, however, it may prove preferable to "freeze" the status as of the date of the bankruptcy filing, so that subsequent changes of status by the debtor do not effect the taxability of interest in the hands of foreign creditors.

will be split into two entities. However, the fact that property of the estate is subject to disposition under two different legal schemes does not require that the estate itself must be given a divided status for tax purposes as well; whenever property is located in two jurisdictions it may be subjected to different legal restrictions, even though the owner is resident in only one, or neither, of the jurisdictions.

134. This probably is the current rule. See Treas. Reg. § 1.641(b)-2(b) (1956), as amended by T.D. 6580 (1961).

CONCLUSION

Given the importance of the conclusion that an individual is a resident of the United States or that a legal entity is domestic, rather than foreign, it is surprising that over the seventy years in which the United States has had an income tax more attention has not been given to the rules governing such determinations. The recently legislated definition of individual residence, while it leaves much to be desired in some respects, appears to bring a needed measure of clarification to the Code.

The "place of incorporation" rule governing the domestic or foreign status of corporations, though crude, affords a desirable degree of predictability, and alternative tests, such as those based on the place of central management and control or the place of effective management, carry with them undesirable factual issues, which will undoubtedly be resolved by most major multinationals in their own favor, while presenting issues of fairness towards smaller companies or those less flexible in the deployment of their personnel. The place of incorporation test should therefore be retained.

Other legal entities—partnerships, trusts, and estates—present definitional issues which seem difficult to resolve in any wholly satisfactory way. The existing law, however, fails to provide clear definitions, with consequent uncertainty and confusion, and seems the least desirable of all solutions. Clearer rules need to be established. In the case of partnerships, it may be possible to dispense with any definition; if not, a definition based on governing law seems appropriate. The domestic or foreign nature of trusts could also appropriately be based on the law governing the rights of the parties. Decedents' estates should appropriately derive their status from that of the decedent. Revocable trusts should for some reasonable period following the settlor's death be governed by the rule for estates.

In all of these cases, the emphasis should be on clarity and predictability, with recognition that, in many cases, parties may freely elect to make an entity domestic or foreign, but must thereafter bear the consequences of their initial choice.