

**TAXATION OF  
INTERNATIONAL  
TRANSACTIONS**  
**MATERIALS, TEXT AND PROBLEMS**  
Third Edition

Charles H. Gustafson  
Robert J. Peroni  
Richard Crawford Pugh

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# TAXATION OF INTERNATIONAL TRANSACTIONS

MATERIALS, TEXT AND PROBLEMS

Third Edition

By

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## Dedication

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We dedicate this book to the thousands of students with whom we have worked and who have helped us to gain insights about tax law and tax law pedagogy.

Professor Gustafson also dedicates this book to his loving and supportive wife, Kate Gustafson.

Professor Peroni also dedicates this book to his loving and supportive parents, the late Emil Peroni and Betty Peroni.

Professor Pugh also dedicates this book to his loving and supportive wife, Nan Pugh.

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## Preface

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The observation that law is being globalized has become something of a cliché. Like many clichés, the observation is true. Practitioners throughout the United States and in other countries are discovering that their work compels them to address problems with international dimensions.

The effects of an increasingly global marketplace, coupled with the mobility of people and ideas, have affected tax practitioners as well. In the United States the taxation of international transactions was once the province of a relatively limited number of specialized practitioners located primarily in a number of major cities. But the rapid growth of trade and investment arrangements that cross national boundaries has changed the picture materially. Attorneys, accountants, consultants and executives who may never have contemplated a career involving international trade and investment are finding themselves involved in business planning decisions that require analysis of many international factors.

This book is designed to serve as an initial step in the process of confronting one aspect of modern international trade and investment realities—the determination and administration of U.S. income tax liabilities resulting from international transactions. This area of the income tax law is particularly complex. There are a number of factors contributing to its complexity. The general complexity of the U.S. tax law is obviously a basic ingredient, as is the complexity of the foreign tax systems that may affect the analysis of any problem. Moreover, international trade and investment transactions are themselves often very complicated, and the complications are compounded by the sometimes conflicting demands of two or more national tax regimes. Technological changes, such as the evolution of electronic commerce, impose new strains on existing rules and procedures. Another source of challenge is the seemingly constant change in the law. U.S. income tax law affecting international transactions has been subject to almost continuous change and adjustment over the past 45 years. In a familiar pattern, many of these changes have evoked tax-avoidance techniques that in turn have attracted further legislative action intended to protect national revenues.

This volume is designed primarily for use in law schools, business schools and schools of management. As an introductory course book, it necessarily leaves some stones unturned and is not intended to be the basis for advice to clients. It does, however, provide students with an opportunity to explore in considerable detail the basic topography of tax considerations that confronts foreign individuals and entities that would participate in the U.S. economy and U.S. individuals and entities that seek to generate income abroad. As such, it will be useful to those who contemplate at least the possibility of further work in the field as well as those who may need or wish to be able to recognize when an international tax specialist should be consulted.

The textual discussion, cases, rulings and other materials in the volume are accompanied by problems designed to demonstrate the operation of the applicable provisions and to provide focus for an examination of the policy considera-

tions that relate to them. Some of the problems are designed to demonstrate specific points. Others provide an opportunity to apply relevant provisions in the context of a tax planning exercise. Many of the problems include references to other countries. Such references are used to facilitate discussion. However, the problems do not actually reflect the laws of any country other than the United States. In a number of instances, the problems require the analysis of the impact of treaty provisions that might be in effect. Such references do not, unless otherwise indicated, represent treaties that are actually in force between the United States and the country or countries identified in the problem.

We fully recognize that there are more materials in the course book than can be addressed in most course or seminar offerings. The book has been prepared with the expectation that professors will choose among topics that are to be addressed in a particular course or seminar offering, and we have sought to facilitate the selection process by using a paragraph numbering system.

Chapter 1 serves as an introduction to the conceptual and administrative considerations that inhere in the establishment of a structure for taxing the income deriving from international transactions. It introduces the principal policy considerations relevant to any evaluation of international taxing provisions. It reflects the influence of international law considerations, including particularly jurisdictional limitations, on the formulation of international tax policy and introduces tax treaties as a source of income tax law to which students may not previously have been exposed.

Chapter 2 reflects the process by which specific items of income and expense are attributed to geographical areas (usually countries) for various tax reasons by examining the so-called "source rules." These source rules are invoked for different purposes throughout the book.

Chapters 3 and 4 deal with "inbound transactions" (the taxation of income realized from investments and activities in the United States by foreign individuals and entities). The effect of tax treaties on inbound transactions is reflected throughout these chapters.

Most of the remainder of the book concerns the U.S. income tax treatment of "outbound transactions" (the taxation of income realized from investments and activities abroad by U.S. individuals and entities). Chapters 5 and 7 deal with aspects of the foreign tax credit and the limitations thereon. Chapter 5 also considers alternative approaches to mitigating international double taxation for U.S. persons, including the foreign earned income exclusion and the impact of tax treaties. Chapter 6 deals with various provisions intended to limit the ability of U.S. investors to avoid or defer U.S. taxes on foreign investment and business activities by using foreign corporations. Chapter 9 deals with issues arising from the use of foreign currencies.

The materials on transfer pricing set forth in Chapter 8 and the materials in Chapter 10 dealing with international tax-free exchanges apply to both inbound and outbound transactions.

Chapter 11 (international sale of goods), Chapter 12 (exploitation of intangible property rights abroad) and Chapter 13 (direct investment abroad) are intended for use in particular by professors who may wish to give an international tax planning emphasis to the treatment of outbound transactions.

Chapter 14 deals with two areas, the anti-international boycott rules and the Foreign Corrupt Practices Act, in which essentially political objectives have been advanced through the use of tax law provisions.

The materials covered in this volume generally reflect developments through October 1, 2005.

We have adopted a number of editing practices for this volume. Most footnotes are omitted from judicial opinions. Those that appear bear their original numbers in the opinions. Deletions of portions of judicial opinions, revenue rulings and other materials are indicated by ellipses.

This volume reflects a revised examination of the issues involved in the taxation of international transactions and introduces some new material not covered in the prior editions of the book. It is by necessity the product of our collective years in the classroom teaching international taxation and our various professional experiences. We are interested in your reflections about it. We have very much appreciated the comments and suggestions by professors and students who have used the earlier editions and welcome comments and suggestions with respect to this edition.

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We wish to express our gratitude to the OECD for permission to use portions of its publications.

We also wish to express our appreciation to the Georgetown University Law Center, the University of San Diego School of Law and the University of Texas School of Law for their support of this project.

The book, although a new work, has a rich ancestry which we wish to acknowledge. It derives from a volume entitled *Taxation of International Transactions* by Charles H. Gustafson and Richard C. Pugh and published by CCH, Inc. That volume in turn was a revised and expanded version of *Taxation of Transnational Transactions* by the late Robert Hellawell, of Columbia University, and Richard C. Pugh, which was also published by CCH, Inc.

CHARLES H. GUSTAFSON  
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