

Global Tax Weekly - A Closer Look, Cross-Border Taxation Of International Communications Income: A Framework For Analysis – United States, (Dec. 20, 2012)

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This is the first article in a planned occasional series in Global Tax Weekly on the international taxation of participants in the major regulated industries. The series begins with a focus on the telecommunications sector.

Business Models in Cross-Border Telecommunications¹

The two principal sets of participants in the cross-border telecommunications sector are satellite providers and wireless providers. The former provide communications services by furnishing access to transponders on satellites (usually “low earth orbit,” or “LEO,” satellites) for end-user voice and data devices and commercial broadcasters; the latter provide voice and data transmission services for end users by delivering access to a land-based wireless communication infrastructure (cell towers).

Satellite providers (such as Iridium and Globalstar) deliver signals from a sending ground station (uplink facility) through their proprietary LEO satellite network to a receiving ground station (downlink facility), which forwards the signal to the end user. Although there are exceptions, in general the provider furnishes a “one-stop” solution directly to users through a vertically integrated set of hardware (satellites, ground stations, end-user equipment).

By contrast, international wireless signal delivery is handled by “roaming” – passing off the signal from one wireless network to another. The “home” carrier, which may have no presence of its own in the “visited” jurisdiction, contracts with the visited network; there is no privity between the end user in the home jurisdiction and the visited network.

Elements of International Tax Analysis

Irrespective of the sector in question, a complete analysis of the international tax position of an industry participant generally requires an answer to each of the following questions:

- What is the legal form of the participant?
- What role (equity owner, financier, operator, withholding agent, etc.) does the participant play in the transaction?
- What is the nature of the income derived or paid by the participant?
- What are the source and character of that income?
- Are there statutory rules focused specifically on the industry or activity?
- Do treaties affect the outcome?

US Tax Rules Governing Cross-Border Telecommunications Activities

Background

The US procedure for taxing international transactions in industries that are subject to specific taxing regimes is to (i) apply tentatively the general US international tax principles to the taxpayers and their activities, and then (ii) add to, subtract from or modify those rules to take account of the relevant industry's customized tax treatment. Thus, in the case of the inter-national telecommunications sector, participants and their transactions are subject to the usual rules of residency and nationality, source and character of income and the like; the results are then modified as needed to take account of the provisions of US tax law that apply specifically to that sector.

As a general proposition, US corporations and individuals² are subject to US federal income tax on domestic and foreign-source income of all types, with a credit (subject to limitations) for foreign income taxes imposed on foreign-source income. Non-US corporations and nonresident individuals who are not US citizens are taxable only on (i) US-source “fixed or determinable annual or periodical income” (“FDAP Income”) and (ii) other income (generally, though not exclusively, from US sources) that is deemed to be “effectively connected” with the conduct of a trade or business within the United States (“effectively connected income” or “ECI”). US shareholders of non-US corporations are taxable on the earnings of such corporations only when those earnings are distributed as dividends, except in the case of certain classes of income earned by non-US corporations (“controlled foreign corporations” or “CFCs”) controlled by a limited number of substantial US shareholders.³ Effectively connected income is taxed, net of allowable deductions, at the normal US corporate income tax rates (plus a branch profits tax, in the case of non-US corporations) and reported on an annual US corporate income tax return; US-source FDAP Income that is not ECI is taxable on a gross basis at a flat 30% rate and subject to withholding at source by the payor. These rules may be modified by treaty.

The source of income (and its cousin, the allocation and apportionment of expenses) is a key component of the analysis for both US and non-US market participants. The foreign tax credit is generally limited to the effective US tax rate on foreign-source taxable income, so the ability of a US taxpayer to avoid double taxation of such income is founded on the proper computation of income from foreign sources (determined under the US sourcing rules). Since most foreign-source income derived by a non-US person escapes US taxation entirely, the source determination is equally critical to overseas companies and investors.

Taxation of Space and Ocean Activity

The US tax law⁴ defines “space and ocean activity” as any activity conducted in space, international waters or Antarctica, except to the extent that the activity gives rise to specified items of income treated elsewhere in the statute, including “international communications income” (discussed below).⁵ In general, such income is sourced within the United States (i) if it is derived by a US person or by a CFC and (ii) to the extent that an analysis of the attendant facts and circumstances leads to the conclusion that the income is not attributable to functions performed, resources employed, or risks assumed in one or more foreign countries. Income from space and ocean activity is sourced outside the United States (i) if it is derived by a non-US person that is not a CFC and (ii) to the extent that an analysis of the attendant facts and circumstances leads to the conclusion that the income is not attributable to functions performed, resources employed, or risks assumed within the United States in connection with a trade or business conducted by the non-US person.⁶

Sales taking place in space are subject to special sourcing rules:⁷

- If inventory property not manufactured by the taxpayer is sold for use outside space or international waters, the sales gain is sourced according to the usual rules for sourcing gain from the sale of tangible personal property (usually, where title and risk of loss pass to the purchaser).
- Other sales of property are subject to a bifurcated process: one half of the gain is deemed attributable to the sales function and sourced under the foregoing rules, with the remainder allocated to the manufacturing function and sourced according to an analysis of the relative functions performed, resources employed, or risks assumed in space or international waters, within the United States, or in a foreign country.

Taxation of “International Communications Income” (“ICI”)

The Code defines “international communications income” as income derived from the transmission of communications or data between (i) a point within the United States and (ii) a point within either (A) a possession of the United States or (B) another country.⁸ Although the Code does not use this nomenclature, it is useful analytically to differentiate among ICI; domestic communications income (“DCI”), derived from transmissions

beginning and ending within the United States; and foreign communications income (“FCI”), derived from transmissions beginning and ending outside the United States.

The Code does not contain a wholly separate regime for the taxation of ICI; rather, the general rules described above are modified in their application to taxpayers earning such income. In particular, [Section 863\(e\)](#) of the Code and the regulations thereunder⁹ modify the source rules with respect to ICI as follows:

- ICI derived by a non-US person (other than a CFC) and attributable to an office or fixed place of business (“FPB”)¹⁰ maintained by that person within the United States is wholly US-source income.
- All other ICI derived by a non-US person is wholly foreign-source income.
- ICI derived by a US person or a CFC is arbitrarily sourced equally within and outside the United States.
- DCI is wholly US-source income, without regard to (i) the location of the FPB to which the DCI is attributable or (ii) the nationality or residence of the person deriving the DCI.
- FCI is wholly US-source income, without regard to (i) the location of the FPB to which the FCI is attributable or (ii) the nationality or residence of the person deriving the FCI.

The Code’s general rules for taxing cross-border activities of US and non-US taxpayers apply unchanged to DCI, FCI and (with the source modifications described above) ICI. Tax treaties to which the United States is a party do not generally deal expressly with communications income; such income is governed for treaty purposes by the relevant treaty’s “Business Profits” article.

Challenges and Uncertainties

There are three principal challenges to the “real world” application of the foregoing rules to cross-border telecommunications activity:

- As in many areas of the tax law, the proper characterization of an activity or a stream of income is both the key gating issue to identifying the correct rule of taxation and a “facts and circumstances” determination that is inherently vulnerable to ambiguity and controversy.
- Many of the determinations required to be made in applying the foregoing rules rely explicitly on an analysis of functions performed, resources employed, and risks assumed by the taxpayer. For example, in determining whether a particular activity gives rise to DCI, FCI or ICI, the taxpayer must determine the location of the two endpoints of the communication “by any consistently applied reasonable method”¹¹ – whatever *that* means. A failure to meet this burden results in a full allocation of the income to US sources; so the endpoint determination, and the reasonableness of the method used to make it, are obviously of critical importance.
- Cross-border telecommunications activity by its very nature requires a taxpayer resident in one country to take account of the tax laws of at least one other country, whose rules covering that activity may differ in scope and nature. This inevitable collision of taxing jurisdictions leads to a very real risk of double taxation of the same item of income, and at a minimum to a substantial compliance burden and ongoing exposure to audit. Proper coordination of these exposures (which may involve dozens of countries) is essential to effective management of the taxpayer’s global tax position.

Conclusion

The issues highlighted above demonstrate that the US tax rules governing participants in the international telecommunications industry have not kept up with either the technological or the regulatory developments in the sector. The subjectivity and uncertainty inherent in analyzing those rules require that market participants pay regular and vigilant attention to the tax dimensions of their operations and initiatives.

Future articles in this series will focus on the interplay of the foregoing US rules with those of the principal international telecommunications markets.

Footnotes

- 1 This article uses the phrase “cross-border telecommunications” to describe activities and income in that industry from a business standpoint, without regard to its characterization for tax purposes.
- 2 Individuals, of course, are rarely found in the ranks of the major telecommunications operators. However, both partnerships and limited liability companies (“LLC”) are forms of business or investment entities that are active in the sector and may have individuals as direct or indirect owners. Such entities (whether organized in the United States or elsewhere) are generally transparent for US tax purposes, so it is ordinarily the tax status of their partners or members that is relevant.
- 3 Specifically, US shareholders owning (i) at least 10% of the non-US corporation’s voting stock individually and (ii) more than 50% of the corporation’s stock (by vote or value) collectively. Rules of attribution apply to determine stock ownership.
- 4 The Internal Revenue Code of 1986, as amended (“Code”) and the Treasury Regulations (“Regulations” or “Reg.”) issued thereunder.
- 5 [Code §863\(d\)](#).
- 6 [Reg. §1.863-8\(b\)](#).
- 7 [Reg. §1.863-8\(b\)\(3\)](#). It is worth noting that the Regulations define “space” negatively as any area (other than international waters) not recognized by the United States as falling within the jurisdiction of any particular country. [Reg. §1.863-8\(d\)\(1\)](#). This can lead to difficult interpretive questions where, for example, a taxpayer conducts transactions in the Earth’s atmosphere.
- 8 Where a location in space or international waters is involved, the resulting income might plausibly be viewed as derived from space and ocean activity, which contains source rules of its own as discussed above. ICI that is so derived is generally sourced exclusively under [Code Section 863\(d\)](#) if both endpoints are in space or international waters, and otherwise under [Code Section 863\(e\)](#). [Reg. §§1.863-8\(b\)\(5\)](#), [1.863-9\(a\)](#), (e), (h)(v).
- 9 [Reg. §1.863-9](#).
- 10 The existence of an FPB is determined under the general rules of [Code §864\(c\)\(5\)](#). ICI is attributed to an FPB by reference to the functions performed, resources employed or risks assumed within the United States.
- 11 [Reg. §1.863-9\(h\)\(3\)](#).