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***207** FEDERAL TAX ISSUES RAISED BY INTERNATIONAL STUDY ABROAD PROGRAMS

Bertrand M. Harding, Jr. [FNa1]

I. INTRODUCTION

The conduct by a college or university of an international study abroad program raises a host of different legal issues ranging from potential liability for injury to the students while overseas to whether U.S. antidiscrimination laws, such as the American with Disabilities Act, should have extraterritorial application. Often overlooked in the menu of different legal issues that merit consideration are tax issues--both U.S. tax issues and those of the country in which the program is conducted. These issues affect the U.S. institution itself as well as any U.S. citizens or foreign nationals who are employed overseas to work for the program. This article will identify and describe these tax issues and suggest steps that a college or university can take to minimize or eliminate adverse U.S. and foreign country tax exposure to both itself and its employees in connection with the conduct of international study abroad programs.

While this article will focus upon and discuss tax issues raised in connection with international study abroad programs conducted by colleges and universities, readers should keep in mind that these same tax principles apply equally to any activities and operations that a U.S. college or university may choose to conduct abroad. If reports in the educational press are any indication, these foreign-based activities are dramatically increasing in both number and significance. Examples over the past few years include: (1) a college located in Atlanta that plans to open a branch campus in the United Arab Emirates [FN1]; (2) a midwestern university that operates a campus in Madrid [FN2]; (3) a New York-based university with campuses in Budapest, Prague, and Warsaw [FN3]; (4) a midwestern university that plans to open a branch campus in Thailand [FN4]; (5) a southwestern university operating a branch campus in Japan; [FN5] and (6) a northeastern university planning to open an international center in Hong Kong. [FN6]

***208** But keeping the focus on the conduct of international study abroad programs, the discussion that follows is divided into two major categories: (1) the U.S. and foreign tax consequences to the U.S. college or university that conducts the international study abroad program, and (2) the same domestic an foreign tax consequences to the individuals, both U.S. citizens and foreign nationals, who provide study abroad program services outside of the U.S.

II. U.S. AND FOREIGN TAX CONSEQUENCES TO THE U.S. COLLEGE OR UNIVERSITY

A. Impact of a Program on the Institution's U.S. Tax-Exempt Status/Unrelated Business Income

As a general rule, if a section 501(c)(3) organization, including a college or university, conducts, as a substantial part of its total operations, an activity that is not in furtherance of the charitable, educational, or scientific purposes for which it was granted exemption, it runs the risk of having the Internal Revenue Service (IRS) revoke its tax-exempt status. [FN7] If an activity is determined by the IRS to be a nonexempt activity, but one that does not comprise a substantial part of the organization's total activities, then the organization will retain its tax-exempt status, but the IRS may choose to tax the net profit from the activity as income from an unrelated trade or business. [FN8]

With one exception discussed below, the operation by a college or university of an international study abroad program will generally not raise any exemption or unrelated business income tax problems because such programs are clearly "educational" in nature and, and such, fall within the scope of the exempt educational purposes of the institution. The fact that the program is conducted outside the U.S. has no effect on the IRS analysis because the agency has long held that a section 501(c)(3) organization is completely free to conduct some or even all of its charitable or educational activities in one or more foreign countries. [FN9] The IRS looks to whether the inherent nature of the organization's activities are charitable or educational, not to the country in which those activities may be conducted, and it is clear that an international study abroad program is inherently educational in nature.

B. U.S. Tax Effect of Operating the Program with Another Entity

The one exception to the general rule that the conduct of an international study abroad program raises no U.S. tax issues for a U.S. college or university relates to the fact that, in conducting the program, schools often enter into a relationship with another entity located either in the U.S. or the foreign country. Such a relationship may be formalized in a written contract that sets forth the duties and responsibilities of each of the parties, or the two parties may operate under an informal unwritten agreement. While most such relationships ***209** are with other nonprofit organizations (such as foreign educational institutions), given the recent proliferation of both for-profit educational institutions and for-profit companies that provide consulting and other services to colleges and universities, it is not unreasonable to assume that a school may conduct an international study abroad program in conjunction with a U.S. or foreign for-profit entity.

If so, the IRS will have a potential concern because when a section 501(c)(3) organization enters into a relationship with a for-profit entity, there is the opportunity for the relationship to be seen as benefiting the non-charitable/educational private interests of that business enterprise. If the U.S. college or university enters into an independent contractor or agency relationship with the for-profit entity, there will generally be no U.S. tax problems because a section 501(c)(3) organization is fully capable of retaining agents or independent contractors, whether nonprofit or for-profit, in the conduct of its educational activities as long as the relationship is established and conducted in an arm's length fashion. If, however, the U.S. institution were to conduct the program through a partnership or joint venture with a U.S. or foreign for-profit entity, the IRS will give the relationship special scrutiny because, in the view of the IRS, partnerships create fertile ground for abuse of section 501(c)(3) status. [FN10]

It was because of this IRS-perceived potential for abuse in partnership relationships that in 1998 the agency promulgated guidelines that set forth rules that must be followed by a section 501(c)(3) organization that enters into a general partnership agreement with a for-profit entity. [FN11] Essentially, these rules say that the partnership agreement must provide that the partnership is required to be operated exclusively for charitable or educational purposes and, most importantly, in order to ensure that the partnership is so operated, the section 501(c)(3) organization must be in control of the partnership in both a formalistic (i.e., ownership of at least 51% of the partnership interest) as well as in de facto or "real world" sense. The Tax Court recently affirmed the IRS position that the nonprofit organization must be in control of any partnership entered into with a for- profit entity. [FN12]

Failure to abide by these rules could result in the IRS asserting that the income of the U.S. college or university is being used to benefit the private interests of the for-profit partner to such an extent as to jeopardize the institution's section 501(c)(3) status. Because it is often difficult for the IRS to justify such a harsh sanction against an accredited college or university that ***210** continues to conduct substantial and bona fide educational activities, a more likely result would be that any net income distributions that may flow to the U.S. institution would be taxed as unrelated business income under special rules in the Code that relate to partnership distributions. [FN13] While this unrelated business income tax fallback position is not expressly set forth in the 1998 IRS guidelines, IRS officials in public presentations have indicated that the agency will take this position, and it has been reported that some IRS agents have asserted fallback unrelated business income positions on audit.

The fact that the arrangement with the U.S. or foreign for-profit entity may not be formally structured as a partnership does not put this issue to rest. Even if a relationship is formally structured as an independent contractor or agency relationship, the IRS is fully capable of recharacterizing any relationship as a partnership and applying the principles set forth in the 1998 guidelines. A "partnership" is defined for tax purposes as an association of two or more persons or entities formed for the purpose of carrying on, as co- owners, a business for profit, [FN14] and whether a partnership exists in any particular situation depends on whether the parties intended to form a partnership, not what they might call the legal relationship. Whether the requisite intent exists is determined by the presence or absence of various objective factors. Such factors that the IRS and the courts have found as evidence of a partnership (even though structured as an agency or independent contractor relationship) include: (1) the intention stated by the parties in the agreement; (2) whether the parties have a mutual interest in both the profits and losses; (3) whether the venture maintains separate financial books; (4) whether there is joint participation in management, joint contribution of capital or services, or joint ownership of the contributed capital; (5) whether representation to others of a partnership relationship; and (6) whether the venture conducts business, holds property, and files tax returns in the partnership name. [FN15]

Therefore, a college or university that enters into an independent contractor or agency relationship with a U.S. or foreign for-profit entity in connection with the conduct of an international study abroad program must be careful that the relationship is not structured in such a manner that the IRS is able to recharacterize it as a partnership. If, however, the IRS recharacterizes the relationship as a partnership, or if it is structured as a partnership in the first place, the college or university must be careful that the "control" and other rules set forth in the 1998 IRS guidelines are followed.

A different set of rules comes into play if the partnership is between the U.S. college or university and a U.S. or foreign nonprofit entity, such as another educational institution, since the IRS's concerns only arise where the ***211** section 501(c)(3) organization's partner is a for-profit entity. [FN16] If the partner is another nonprofit organization, the IRS will be concerned only that the activity that is the subject of the joint venture (i.e., the international study abroad program) is an activity that is in furtherance of the U.S. college or university's exempt purposes, which will normally be the case. The IRS will likely take such a position even if the other entity is a foreign nonprofit institution that is not itself recognized by the IRS as exempt under section 501(c)(3), particularly if it has equivalent tax-exempt status in its home country.

C. Whether Operation of the Program Will Subject the Institution to Tax in the Foreign Country

Whether the U.S. college or university operates the international study abroad program in conjunction with another U.S. or foreign entity or whether it operates the program itself, the most significant tax issue will generally be whether the activities of the U.S. institution in that country will be of a sufficient scope and magnitude to cause it to be subject to the foreign country's income tax. Many U.S. colleges and universities instinctively belive that because they enjoy income tax exemption in this country, they will automatically enjoy such status in a foreign country. But this is not so. Unless the institution can qualify for a tax exemption under the law of the foreign country (assuming such an exemption exists), it will generally be subject to that country's income tax if the institution's activities in the foreign country cause it to have a sufficient presence there. [FN17]

In determining whether a U.S. institution's activities in the foreign country are of a sufficient scope or magnitude to cause it to be subject to income tax in that jurisdiction, the institution must first determine whether the U.S. has entered into an income tax treaty with the country. An income tax treaty is a bilateral agreement between two countries that is primarily designed to avoid double taxation and foster international trade. As of this writing, the U.S. has entered into tax treaties with more than 50 different foreign countries. [FN18] A tax treaty is negotiated and entered into by the two countries primarily for the benefit of each country's business interests, and there are no treaties that ***212** provide that certain types of nonprofit organizations (e.g., colleges and universities) are exempt from the other country's income tax. Thus, a U.S. college, university, or other nonprofit institution is viewed for tax treaty purposes in exactly the same manner as a for-profit business entity.

Each income tax treaty has what is known as a "permanent establishment" article, which overrides local law and defines they type and scope of activities that give each country the jurisdictional nexus to tax the activities of the other country's residents. If under this tax treaty article the U.S. college or university is determined to have a "permanent establishment" in the foreign country, it is subject to income tax in that jurisdiction, unless there exists a local exemption for charitable/educational organizations and it can meet the exemption qualifications. By contrast, if the U.S. institution's activities in the treaty country do not create a "permanent establishment" under the treaty article, the country does not have the jurisdiction to subject the institution to its income tax.

To illustrate: Assume that a U.S. university is planning to conduct an international study abroad program in Germany. The university would want to review carefully Article 5 of the U.S.-Germany tax treaty, which defines the nature and scope of the activities that will be treated as creating a German "permanent establishment." [FN19] Although each tax treaty to which the U.S. is a party is different and must be individually examined, the "permanent establishment" article in the U.S.-Germany tax treaty is a good illustration because the treaty is relatively recent (1989) and reflects the current thinking of the U.S. Treasury Department in the permanent establishment area. [FN20] Before reviewing Article 5 of the U.S.-Germany tax treaty, however, it is important to point out that tax treaties in general, and "permanent establishment" articles in particular, are not drafted with nonprofit organizations in mind; rather, they are written from the standpoint of for- profit business enterprises. Therefore, many tax treaty provisions, by their very terms, are inapplicable to nonprofit organizations, and other provisions are unclear as to how they apply to nonprofit activities.

Keeping this in mind, the "permanent establishment" article of the U.S.- Germany tax treaty reads as follows:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

***213** (d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or a construction, assembly or installation project

constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the foregoing provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of advertising, of the supply of information, of scientific activities, or of similar activities that have a preparatory or auxiliary character for the enterprise; or

(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provision of paragraph 1 and 2, where a person (other than an agent of an independent status to whom paragraph 6 applies) is acting on behalf of an enterprise and has, and habitually exercises, in [Germany] an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in [Germany] in respect to any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in [Germany] merely because it carries on business in [Germany] through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company that is a resident of [Germany] controls or is controlled by a company that is a resident of [the United States], or that carries on business in [the United States] (whether through a perma ***214** nent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other. [FN21]

The difficulty in applying the principles set forth in this treaty article to the operation of an international study abroad program in Germany becomes immediately apparent because the terms and concepts used in the provision are all business-related. This leads to an obvious question--looking at Paragraph 1, which sets forth the fundamental definition of a "permanent establishment," can it be argued that a college or university (or any nonprofit entity) cannot, by definition, have a "fixed place of business through which the business of an enterprise is wholly or partly carried on" because there is no "business" being conducted by the college or university? Such a position, if it has ever been asserted by a nonprofit entity, has never been upheld by the IRS or the courts, and in fact, there is authority to support a contrary position. [FN22] Rather, a college or university conducting an international study abroad program (or any other activity) in a treaty country must test its operations against the terms of the applicable tax treaty's "permanent establishment" article without regard to its nonprofit status or its charitable or educational activities and must try, as best it can, to fit its activities into the tax treaty language.

Therefore, if a U.S. educational institution conducts an international study abroad with its own office space or employees in Germany, it will likely be deemed to have an "office" or a "branch" in Germany under Paragraph 2. As such, unless one of the Paragraph 4 exceptions is applicable, it will have a permanent establishment in that country. The Paragraph 4 exceptions, however, are obviously framed in terms of manufacturing or services business and have no application to the conduct of a study abroad program.

Let's assume that the U.S. college or university does not operate the program itself, but enters into a contractual relationship with a German entity to do so. It does not have an office or branch in Germany, and therefore will not be treated as having a permanent establishment under Paragraph 2. The nature of the relationship with the German entity, however, may create the permanent establishment. Under Paragraph 5 if the program is structured so that it is operated by an agent in Germany (not an independent contractor) and that agent has the power to execute contracts on behalf of the U.S. school (and habitually does so), the school will have a permanent establishment in Germany. If, however, the agent does not have the power to execute contracts on the school's behalf (or does not habitually do so), the fact that the school has a German agent will not cause it to have a German permanent establishment. Finally, if the U.S. school has no office or branch in Germany and the program is operated not by the school's agent but by an entity that ***215** acts as an independent contractor, under Paragraph 6 there is no permanent establishment.

These complex rules illustrate and underscore why it is essential that a U.S. college or university planning to conduct an international study abroad program (or any activity) in a foreign, tax treaty country have a clear understanding of the treaty's permanent establishment clause so as to be able to structure the program--for example, through an independent contractor relationship or an agent that cannot execute contracts on its behalf--so it is not treated as subject to the taxing jurisdiction of that country. Even so, difficult questions can still arise. For example, assume that a U.S. college or university engages a foreign educational institution to conduct the study abroad program, and it is clear that the foreign institution is acting as an independent contractor. In view of the nonprofit nature of the foreign institution and the fact that it may not engage in any other study abroad activities, can it be said that the foreign institution is acting "in the ordinary course of its business" under Paragraph 6? Unfortunately, there are no answers to these and similar questions that routinely arise when trying to fit nonprofit operations into the business-related language of a tax treaty.

The foregoing discussion and analysis relates only to programs conducted in countries with which the U.S. has a tax treaty, and there are, of course, many more countries with which the U.S. does not have a tax treaty. In these cases, a determination as to whether the school's operations in that country will subject the school to the country's taxing jurisdiction depends on that country's local laws, and an authoritative answer to this question requires the advice of local legal counsel. The tests will vary from country to country, both as to the substantive "doing business" requirements imposed by local law and, sometimes more importantly, to the practical extent to which those laws are actually enforced by the local tax authorities.

D. Tax Consequences of Conducting the Program Alone

If a college or university is planning to conduct an international study abroad program in a foreign country by itself without the assistance or cooperation of other U.S. or foreign entities, another issue that has both tax and non-tax consequences is how to structure the legal entity that will actually conduct these operations. There are two basic choices: (1) the program can be conducted through a branch of the U.S. college or university in the foreign country, or (2) the institution can create a separate, controlled legal entity in the foreign country to conduct the program. If the institution chooses to operate the program through a foreign country branch, the U.S. institution will, in all likelihood, be subject to that country's taxing jurisdiction, whether under a tax treaty "permanent establishment" article or, if no treaty exists, under the country's local laws. Such an institution would be well advised to retain local tax experts to assist in compliance with all local tax and reporting laws.

On the other hand, if the institution decides to operate the program through a holly-owned subsidiary formed in the foreign country, the different***216** types of legal entities available in that country must be analyzed to see which is best suited to conduct the activities. As just one example, if a U.S. college or university were planning to conduct for-profit operations in France, it could choose to conduct its activities through (1) a societe a responsibilite (limited liability company); (2) a societe anonyme (joint stock company); (3) societe en non collectif (general partnership); or (4) societe en commandite simple (similar to a limited partnership under U.S. law). If the U.S. institution wanted to conduct the program in France through a nonprofit entity, it would most likely use an "association loi 1901," which has no shareholders and is required to transfer its assets only to another nonprofit entity. Whichever type of entity is created, it is that entity (not the U.S. college or university) that will be subject to tax in the foreign country. Again, local tax experts must be retained to determine whether the entity might be exempt from tax, and if not, to ensure that it meets all of its foreign country tax and reporting requirements. Of course, it might also be possible for the U.S. institution to enter into a relationship with its own subsidiary so that it is treated as having a permanent establishment in that country. For example, if it establishes the foreign country subsidiary as its agent and gives the subsidiary the right to execute contracts on its behalf, it may be treated as having a permanent establishment in that foreign country.

There are also some practical, non-tax considerations in deciding whether to operate through a branch or a local legal entity. The advantages of operating through a branch include the following:

1. A branch is simpler and less expensive to operate due to reduced filing and accounting costs. In addition, there are usually no foreign capital or stamp taxes imposed on a branch as there are with corporations.

2. Most foreign countries do not impose a withholding tax on branch profits that are remitted back to the U.S.

3. A foreign branch is generally not subject to local control restrictions, while a local corporation may be required to have foreign shareholders and/or directors.

4. Assets can generally be transferred between the branch and the institution free of any tax since there is no change in the ownership of the transferred assets.

At the same time, however, there are several advantages of operating through a foreign corporate subsidiary. They include:

1. The subsidiary is generally afforded limited liability. A branch is an extension of the U.S. college or university; therefore, all tax and other liabilities to which the branch will be subject will constitute liabilities of the U.S. institution.

2. Any disclosures to the foreign government will generally be limited to the subsidiary, while a branch may have to disclose information about the U.S. institution itself.

***217** 3. A local subsidiary generally presents a better public image and is sometimes better able to obtain local borrowings, incentive payments, and grants.

4. The subsidiary may be eligible for a local tax exemption, whereas it may be more difficult (administratively and substantively) for the U.S. institution that operates in the country through a branch to obtain local tax-exempt status.

III. TAXATION OF U.S. AND FOREIGN NATIONAL EMPLOYEES INVOLVED IN THE PROGRAM

When a U.S. college or university conducts an international study abroad program in a foreign country, it is not uncommon for it to send its own U.S. citizen employees (either existing or newly hired) to the foreign country to work. In addition, the school may hire local citizens to assist in the operation of the program.

When a college or university sends its own U.S. citizen employees to the foreign country, an issue that arises is whether and to what extent these employees may be subject to tax in both the U.S. and the foreign country on the wages paid to them. A corollary question from the U.S. institution's own standpoint is whether and to what extent it may have its own U.S. or foreign country tax withholding and reporting obligations with respect to the wage payments made to these U.S. citizen employees. The answers to these questions depend on the legal structure (branch or wholly-owned subsidiary) through which the U.S. college or university chooses to conduct this foreign activity. Each of those situations is discussed below.

A. Operating Through a Branch

If the U.S. college or university conducts the study abroad program in the foreign country through a branch, both the U.S. citizen and foreign national employees are treated as employees of the U.S. institution. The U.S. citizen employees will continue to be subject to U.S. tax because the U.S., unlike most other countries, taxes its citizens on their worldwide income. [FN23] With one important exception, therefore, it makes no difference for a U.S. citizen employee whether the wages are paid for work performed in the U.S. or abroad. That exception relates to the "foreign earned income exclusion" set forth in section 911 of the Code. Under this provision, if a U.S. citizen employee makes a timely election to claim the benefits of section 911, [FN24] the employee is able to exclude from his or her gross income (1) up to $76,000 per year of "foreign earned income," and (2) a "housing cost amount," which is ***218** generally equal to the employee's actual housing costs less a housing base amount. [FN25]

The section 911 rules raise a number of complex and technical issues as to how these provisions apply, but the most important of these issues is whether the U.S. citizen's presence in the foreign country is sufficient to qualify for the exclusion. There are two separate tests that are used to make this determination--either (1) the U.S. citizen must be a "resident" of the foreign country for an uninterrupted period that includes at least an entire taxable year, or (2) during a period of 12 consecutive months, the U.S. citizen must have been physically present in the foreign country for at least 330 full days. [FN26] Assuming that the institution's U.S. citizen employee working overseas in an international study abroad program qualifies for the section 911 exclusion, it is important to note that the institution is not required to withhold any U.S. income tax on the amount of the excluded wages, assuming that the employee properly notifies the institution of his or her intent to claim the section 911 exclusion. [FN27]

In addition to U.S. income tax, a question also arises as to whether the U.S. employee and the U.S. college or university are subject to U.S. social security taxes on the wages paid. Because the social security taxes apply to all U.S. citizens working for a U.S. employer, regardless of the physical location of the employment, the social security tax obligations of both the U.S. institution and the employee are usually the same as if the person were employed in the U.S. [FN28] There is an exception to this general rule, however, when the foreign country involved is one with which the U.S. has entered into a social security "totalization" agreement, which is similar in nature to in income tax treaty except that the subject of the agreement relates to social security-type taxes and eligibility for social security benefits. The U.S. has entered into social security totalization agreements with 17 different countries. [FN29] The purpose of these agreements is to eliminate double social security taxation and to permit persons paying social security tax to the foreign country to be able to obtain credit for subsequent social security coverage in their home country.

***219** A typical U.S. social security agreement is the one entered into with the United Kingdom. Under this agreement, the general rule is that a person who is a citizen of one of the countries and sent to work in the other country will be subject to the social security tax of the other country. [FN30] For example, if a U.S. college sent an employee to the U.K. to work on an international study abroad program, under this general rule, the employee would be subject to U.K. social security tax, but would receive credit toward eventual U.S. social security coverage for the payments made to the U.K. There is, however, a major exception to this general rule, which says that, if the person is sent to the other country for a period not expected to last more than five years, the person will continue to be subject to the home country's social security tax. [FN31] So, in the above example, if the U.S. college employee were expected to stay in the U.K., say, for only three years, the person would continue to pay U.S. social security tax.

If the U.S. institution operating through the foreign branch also employs foreign country nationals, there are no U.S. income tax obligations imposed on the foreign national employee and no U.S. tax withholding or reporting obligations imposed on the U.S. institution. This is because a non- U.S. citizen or resident is subject to U.S. income tax only on his or her "U.S. source income," and payments received for personal services rendered by such a person outside the U.S. are considered under U.S. tax law to be "foreign source income" and not subject to U.S. income tax. [FN32] To the extent, however, that the foreign national employee comes to the U.S. to conduct any employmentrelated activities, the individual would be subject to U.S. income tax on the wages allocable to those activities, and the institution would be required to withhold U.S. income tax, unless the wage payment qualifies for an exemption under a tax treaty between the U.S. and the foreign country. [FN33] Likewise, foreign national employees are not subject to the U.S. social security taxes as long as their services are performed outside the U.S.; if, however, they conduct any employment activities in the U.S., the social security tax provisions are applicable to both the employee and the U.S. institution, again, unless a social security agreement between the two countries dictates a different result. [FN34]

Finally, U.S. citizens or foreign nationals employed to work for the study abroad program in the foreign country may be subject to the foreign country's income tax by reason of their conducting employment-related activities in that country. While they should be able to credit any income taxes paid to the foreign country against their U.S. income tax liability, the fact that foreign income taxes have to be determined, foreign income tax returns have to ***220** be filed, and offsetting U.S. tax credits have to be computed is complicating for U.S. citizens working abroad. In addition, many countries have social security-type taxes, and some countries impose types of taxes on individuals residing and working in that country that have no U.S. counterpart. These taxes, if applicable, also have to be taken into account. Also, the local tax laws may impose an obligation on the part of the foreign employer (the U.S. institution) to withhold and pay over taxes to the local taxing authorities and file reports describing the nature and amounts of the payments made and the taxes withheld. In all cases where a U.S. college or university makes wage payments to U.S. citizen or foreign national employees working in a foreign country, the institution must determine the extent to which it may have local tax withholding and reporting obligations. This can usually be done only by consultation with local accounting firms or legal counsel.

B. Operating Through a Wholly-Owned Subsidiary

If the U.S. college or university chooses to conduct the study abroad program in the foreign country through a local legal entity of some type (e.g., a local nonprofit corporation), the U.S. and foreign national employees will, of course, be treated as employees of that legal entity. Again, the U.S. citizen employees will be subject to U.S. income tax on the wages paid to them because of the U.S. law that taxes its citizens on their worldwide income, regardless of the nationality of the employer. The U.S. citizen employees would still qualify for the section 911 "foreign earned income" exclusion, assuming they met either the above-described "residency" or "physical presence" tests. One significant difference resulting from the fact that the employer is a foreign legal entity, however, is that the U.S.citizen employees would not be subject to U.S. social security tax because that tax is only imposed on a U.S. citizen working overseas if the individual is working for a U.S. employer. [FN35] It may also be that the U.S. citizen will not be eligible to participate in a desired U.S.-based retirement plan because it is the practice of some retirement plans to limit participation to employees of U.S. employers only.

The remaining tax issues--taxation of the U.S. citizen and foreign national employees in the foreign country, and the employer's local tax withholding and reporting obligations--are matters of local tax law, and the U.S. institution contemplating operations in a foreign country through a local legal entity must use local accountants, or legal counsel, or both, to ensure that the legal entity, as the employer, and all its employees are aware of and in compliance with their local tax obligations.

IV. CONCLUSION

Given the number and complexity of the many different legal considerations that arise when a college or university decides to engage in an international study abroad program, it is not surprising that U.S. and foreign tax ***221** considerations are often ignored or overlooked. But, as can be seen from the foregoing discussion, the manner in which the U.S. college or university conducts the study abroad program in the foreign country can adversely affect its own U.S. tax-exempt status or potentially subject it to the unrelated business income tax. In addition, care must be exercised to determine whether this activity may subject the U.S. institution to tax in the foreign country. If so, the institution will be required to calculate the extent and amount of that foreign tax. Finally, the U.S. college or university will be required to determine the nature and extent of any U.S. or foreign country income or social security taxes with respect to wages that it pays to U.S. citizens or foreign nationals employed to work on the study abroad program. Again, it is important to note that the same U.S. and foreign tax considerations come into play not only in connection with the conduct of international study abroad programs but also with respect to any activities that the U.S. institution conducts overseas.

[FNa1]. B.A. Duke University, 1968; J.D. George Washington University, 1975. Mr. Harding operates his own law firm in Washington, D.C., specializing in college and university tax issues. He is the author of THE TAX LAW OF COLLEGES AND UNIVERSITIES, published by John Wiley & Sons, 1996.

[FN1]. Dispatch Case, CHRON. OF HIGHER EDUC., June 16, 1995, at A37.

[FN2]. Dispatch Case, CHRON. OF HIGHER EDUC., June 23, 1995, at A33.

[FN3]. Dispatch Case, CHRON. OF HIGHER EDUC., July 28, 1995, at A43.

[FN4]. Dispatch Case, CHRON. OF HIGHER EDUC., Aug. 11, 1995 at A35.

[FN5]. Dispatch Case, CHRON. OF HIGHER EDUC., Dec. 8, 1995 at A37.

[FN6]. Dispatch Case, CHRON. OF HIGHER EDUC., May 3, 1996 at A43.

[FN7]. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1999).

[FN8]. I.R.C. § 511 (1999). In order for the net income to be taxed under the unrelated business income tax rules, the activity must also be a trade or business and must be regularly carried on. See I.R.C. § 512(a)(1) (1999); Treas. Reg. § 1.513-1(b) and (c)(1) (1999).

[FN9]. Rev. Rul. 71-460, 1971-2 C.B. 231.

[FN10]. At one time, the IRS took the position that any section 501(c)(3) organization entering into a general partnership with a for-profit entity would automatically lose its taxexempt status, even if the partnership conducted purely charitable or educational activities. Gen. Couns. Mem. 36,293 (May 30, 1975). After several court defeats, however, the IRS relaxed this rule and said that a section 501(c)(3) organization could enter into a partnership with a for-profit entity but only if the organization's participation in the partnership (1) furthers an exempt purpose, and (2) does not confer a private benefit on the for-profit partner. Gen.

Couns. Mem. 39,005 (Dec. 17, 1982).

[FN11].Rev. Rul. 98-15, 1998-1 C.B. 718.

[FN12]. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999).

[FN13]. I.R.C. § 512(c) (1999).

[FN14]. I.R.C. § 7701(a)(2) (19f99); see also Uniform Partnership Act, § 6(1).

[FN15]. Long v. Commissioner, 77 T.C. 1045 (1981); Podell v. Commissioner, 55 T.C. 429 (1970); Kahn Estate v. Commissioner, 499 F.2d. 1186 (2d Cir. 1974); Luna v. Commissioner, 42 T.C. 1067 (1964).

[FN16]. Given the aforementioned definition of a "partnership" as requiring the conduct of a business for profit, it is arguable that such a relationship between two nonprofit organizations would not be treated as a partnership in the first place.

[FN17]. For a more detailed discussion and analysis of the nonprofit law, in foreign countries, see LESTER M. SALOMON, THE INTERNATIONAL GUIDE TO NONPROFIT LAW (1997).

[FN18]. Australia, Austria, Barbados, Belgium, Canada, People's Republic of China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakstan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, United Kingdom, and Venezuela. The old U.S.-U.S.S.R. tax treaty applies to all of the former Soviet republics, except those that have negotiated their own treaty with the U.S. As of this writing, only Russia and Kazakstan have negotiated their own treaties, but Ukraine is reportedly close to finalizing a tax treaty with the U.S.

[FN19]. See Convention Between the United States of American and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., art. 5, 1708 U.N.T.S. 3.

[FN20]. See id.

[FN21]. Id.

[FN22]. See Rev. Rul. 83-144, 1983-2 C.B. 295 (holding that a nonprofit Philippine pension trust with an office in the U.S. does not have a U.S. permanent establishment under the U.S. - Philippine income tax treaty because it was trading for its own account. The IRS did not reach this conclusion on the ground that a nonprofit entity is definitionally unable to conduct a trade or business under the permanent establishment article).

[FN23]. I.R.C. § 61 (1999).

[FN24]. The election is made by filing Form 2555 (Foreign Earned Income) together with a timely filed tax return, or an amended return. Once made, the election remains in effect until revoked. Treas. Reg. § 1.911-7 (1999).

[FN25]. The term "foreign earned income" is defined in Treas. Reg. § 1.911-3 (1999); the qualified "housing expenses" are defined in Treas. Reg. § 1.911-4(b) (1999); and the calculation of the "housing base amount" is set forth in Treas. Reg. § 1.911-4(c) (1999). For a more detailed explanation of the I.R.C. § 911 rules, see IRS Publication 54 (Tax Guide for U.S. Citizens and Resident Aliens Abroad). Also, the $76,000 annual exclusion is indexed and increases to $78,000 in 2001 and to $80,000 in 2002 and thereafter. I.R.C. § 911(b)(2)(D) (1999).

[FN26]. The individuals who qualify for the I.R.C. § 911 exclusion are described in Treas. Reg. § 1.911-2 (1999).

[FN27]. Treas. Reg. § 31.3401(a)(8)(A) (1999). In order to avoid withholding, the employee must file with the employer a completed Form 673 (Statement for Claiming Benefits Provided by § 911 of the Internal Revenue Code).

[FN28]. I.R.C. § 3121(b) (1999).

[FN29]. Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

[FN30]. Part II, Article 4.1, Agreemeni on Social Security Between the United States of America and the United Kingdom of Great Britain and Northern Ireland (the "U.S-U.K. Social Security Treaty"), effective January 1, 1985; TIAS 11086.

[FN31]. Part II, Article 4.2, U.S.-U.K. Social Security Treaty.

[FN32]. I.R.C. § 871 (1999) (limiting tax on nonresident aliens to U.S. source income); I.R.C. § 861(a)(3) (1999) (setting forth the sourcing rules for personal services income).

[FN33]. I.R.C. § 861(a)(3) (1999).

[FN34]. I.R.C. § 3121(b) (1999).

[FN35]. I.R.C. § 3121(b) (1999).

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