North Carolina Journal of International Law

Volume 4 | Number 2 Article 5

Winter 1979

Tax Implications of Exporting

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SPECIAL LEGAL PROBLEMS

Tax Implications of Exporting

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The purpose of this paper is to outline the U.S. and foreign tax consequences of involvement in foreign markets by U.S. companies. The first section explains the tax consequences of a relatively simple exporting business with no overseas presence and describes U.S. tax incentives for exporters in some detail. The second section explains the foreign taxation of royalty payments from a foreign entity to a U.S. company for use of its patents or know-how, and how the foreign income taxes are treated for U.S. tax purposes. The third section deals with the tax implications of a U.S. exporter having sales operations overseas. The fourth section explains the concept of a tax haven and restrictions on the use of tax havens. The fifth section gives an overview of some special tax and legal problems of doing business with countries involved in boycotts of Israel.

I. Exporting Via Independent Distributors

The simplest way for a U.S. entity to sell to overseas customers is through an independent distributor. In this case, the export documents would be handled by the unrelated distributor. Generally there would be no foreign income taxes, and the only significant tax would be the U.S. tax. The United States gives a tax incentive to exporters by means of a special tax category for certain corporations, the Domestic International Sales Corporation (DISC).[1] A DISC pays no U.S. tax. The manufacturer achieves tax deferral by setting up a DISC and channelling part of its export income through the DISC. Roughly one-half of a manufacturer's export income can be channelled through the DISC, and of that part fifty percent is deemed to be distributed to the DISC's stockholder. The remaining twenty-five percent can be accumulated in the DISC, free of tax, as long as the DISC can invest it in qualifying assets. This is equivalent to an interest-free loan of indefinite duration of one

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[1] I.R.C. §§ 991-997, Treas. Reg. §§ 1.991-.997 (1974).

quarter of the tax on a manufacturer's income from exports. As will be explained, this benefit is significantly less for older DISCs.

Following is a description of the types of exports that qualify for DISC benefits, the requirements which must be fulfilled to qualify as a DISC, the mechanics of DISC deferral, the uses of accumulated DISC income, the benefits of Western Hemisphere Trade Corporations (WHTCs) as opposed to DISCs, and conjecture on the future of the DISC provisions.

A. *Exports which qualify for DISC benefits*[2]

Ninety-five percent of a DISC's gross receipts must be "Qualified Export Receipts." Qualified Export Receipts are mainly receipts from the sale, exchange, lease or rental of export property, and receipts from the performance of engineering or architectural services for construction projects outside the United States. Export property must have been manufactured, produced, grown or extracted in the United States by someone other than the DISC, *i.e.*, the DISC's supplier. The DISC can perform some minor assembly and packaging. The property must be held primarily for sale, lease or rental in the ordinary course of business, for direct use, consumption or disposition outside of the United States. Not more than fifty percent of the fair market value of the property can be from components imported into the United States. (This can be tricky if a product is exported from the United States, perhaps for processing by low-cost labor, and then reimported for final manufacturing before being sold overseas. When the property comes back into the United States, all of its fair market value at that point will be considered foreign.) There are categories of property which cannot get DISC benefits, such as know-how, patents, formulas, copyrights and percentage depletable products of which at least fifty percent of the fair market value does not come from manufacturing.

B. *Requirements to qualify as a DISC*[3]

A DISC is basically a paper corporation, but there are a number of requirements that must be strictly adhered to in order to avoid disqualification. A DISC must be incorporated in the United States, it must elect to be a DISC and it must file a DISC return. It must have the following characteristics: $2,500 capital, paid in cash or property; its own bank account each day of the tax year; and its own books and records, even though the only entries ordinarily made on the books will be on closing. Ninety-five percent of a DISC's gross receipts must be Qualified Export Receipts, which are primarily sales of the export property described above. Ninety-five percent of a DISC's assets at the end of its tax year

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[2] I.R.C. § 992(a)(1)(A), Treas. Reg. § 1.992-1(b) (1974); I.R.C. § 993, Treas. Reg. § 1.993-1, -2, -3 (1977).

[3] I.R.C. § 992, Treas. Reg. § 1.992-1, -2, -3, -4 (1977).

must be Qualified Export Assets, which is a very substantial problem for older DISCs (elaborated on below). Although most of the DISC requirements are very formalistic, they must be strictly adhered to or the Internal Revenue Service (IRS) will disqualify the DISC and end the deferral.

C. *Mechanics of DISC deferral—Income*

Almost all DISCs are paper corporations and serve only a tax function. Normally the IRS would not allow a corporation to artificially shift income to an entity which served only a tax purpose. DISCs, however, come under special intercompany pricing rules[4] which allow them to earn specified amounts of income regardless of the function they perform. Of course, the rare DISC which does perform a function can charge an arm's-length price. The pricing methods available to a DISC are the four percent method and the fifty percent method. The four percent method allows a DISC to earn four percent of the gross receipts from exports, plus ten percent of its export promotion expenses. The fifty percent method allows the DISC to earn fifty percent of the DISC's and supplier's combined taxable income from exports, plus ten percent of export promotion expenses. Export promotion expenses are, in general, all the costs which enhance sales outside the United States, including installation, warranties, billing, clerical costs, market studies, salaries, rent, sales commissions, depreciation, freight, packaging and package design.[5] They must be incurred by or on behalf of the DISC.

For example, suppose a manufacturer had export sales of $14,000,000, cost of goods sold of $11,000,000, export promotion expenses of $600,000 and other expenses of $400,000. To calculate allowable DISC income:

Sales	$14,000,000
Cost of goods sold	(11,000,000)
Export promotion expenses	(600,000)
Other expenses	(400,000)
Income from exports	2,000,000
4% Method	
14,000,000 × .04	560,000
600,000 × .10	60,000
	620,000
50% Method	
2,000,000 × .50	1,000,000
600,000 × .10	60,000
	$1,060,000

Because the fifty percent method gives the greater income, the DISC

[4] I.R.C. § 994, Treas. Reg. § 1.994-1, -2 (1975).

[5] I.R.C. § 994(c), Treas. Reg. § 1.994-1(f) (1975).

would use it and would be allowed to earn $1,060,000 on the sales. The DISC can earn this income either by taking a commission on the sales or by buying and reselling the export goods at appropriate prices. Accordingly, DISCs are often referred to as commission DISCs or buy-sell DISCs.

In order to use the fifty percent or the four percent method, a DISC must have a written supplier's agreement[6] which allows it to do so. Usually these agreements are written in terms which specifically allow the DISC to earn the maximum allowable amount under the DISC regulations.

D. *Mechanics of DISC deferral-deemed distributions*[7]

The DISC pays no tax on the income it earns. However, each year the DISC is deemed to make a distribution to its shareholders, and those shareholders are taxed on the deemed distribution. Before the Tax Reform Act of 1976, the deemed distribution was principally one-half of the DISC's income.[8] The 1976 Act increased the deemed distribution by the non-incremental income of the DISC. In other words, instead of deferring tax on one-half of its income, a DISC can now only defer tax on one-half of that income which is attributable to an increase in exports over sixty-seven percent of exports in a defined base period.[9] DISC income attributable to growth in exports is defined by the following formula:

$$\frac{\text{Current Year Export Gross Receipts} \quad \text{Less} \quad 67\% \text{ of Base Period Export Gross Receipts}}{\text{Current Year Export Gross Receipts}} \times \text{DISC taxable income}$$

Base period export gross receipts are defined as average gross receipts in a defined base period. For 1978 and 1979 the base period is 1972 through 1975. In 1980 the base period begins to roll forward one year for each year beyond 1979.

To show the mechanics of the incremental rule and the deemed distribution, assume that the above example took place in 1978 when the DISC's taxable income was $1,060,000 and that the DISC had the export gross receipts for prior years shown below. To calculate deemed distribution:

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[6] A supplier's agreement is defined in Treas. Reg. § 1.993-1 (l), (2) (1977). It refers to an agreement respecting a transaction between the DISC and its related supplier. The agreement must be written and entered into before the transaction. It covers the price payable by the DISC or the commission payable to the DISC. A related supplier is defined in Treas. Reg. § 1.994-1(a)(3) (1977). It is a "person" controlled directly or indirectly by the same interests as the DISC and "singly engages" in a transaction with the DISC. These regulations allow the related supplier to determine the transfer price paid to the related supplier by the DISC or the commission paid to the DISC.

[7] I.R.C. § 995(b), Treas. Reg. § 1.995-2, -3 (1974).

[8] I.R.C. § 995(b)(1)(F)(i) as amended by the Tax Reform Act of 1976. Treas. Reg. § 1.995-(2)(a)(4) (1974).

[9] I.R.C. § 995(e)(3). The Treasury Regulations do not incorporate the 1976 amendments (Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101, 90 Stat. 1520 (1976)). *See also* [1978] 6 FED. TAX. (CCH) ¶ 4399P.045, ¶ 4399R.02.

Export gross receipts for base period	
1972	$13,601,000
1973	15,042,000
1974	11,985,000
1975	13,400,000
TOTAL	$54,028,000
Divide by number of years in base period	÷ 4
Equals average export gross receipts for base period	$13,507,000
Multiplied by	× 67%
Equals adjusted base period export gross receipts	$ 9,050,000
Taxable income attributable to excess over adjusted base period export gross receipts:	
$\frac{\$14,000,000 - \$9,050,000}{\$14,000,000} = 35.36\% \times \$1,060,000 = \$$	375,000
50% of this income is deferred	× 50%
Deferred DISC income	187,000
Multiplied by tax rate	× 46%
Equals deferred tax	$ 86,000

Because the incremental calculation is based on base period export gross receipts, it has the least effect when those receipts are low relative to current year receipts. For a new DISC, the incremental rules have no effect because the DISC has no base period. For a DISC with a base period, the faster current export gross receipts grow, the smaller the effect of the incremental rules. These effects are shown in the following tables. The effect of the incremental rules is also somewhat reduced for small DISCs.

Table I

Effect of *growth rate* on incremental rules for years 1979 and thereafter (assume a DISC with export gross receipts in each base year; no effect of small DISC rules)

(A) Annual compound rate of growth of export gross receipts	(B) Adjused taxable income attributable to base period export gross receipts	(C) Percentage of DISC income deemed distributed $(B) + \frac{100-(B)}{2}$	(D) Percentage of total export income deferred from tax $\frac{100-(C)}{2}$	(E) Effective current taxation of combined taxable income 46%−46% (D)
0	67%	84%	8%	42%
10%	40%	70%	15%	39%
20%	25%	63%	19%	37%
30%	17%	59%	21%	36%
40%	11%	55%	22%	36%
50%	8%	54%	23%	35%

Table II

Effect of incremental rules on a *new DISC*
(assume a DISC started in 1977, no effect of small DISC rules, *zero growth*)

Tax year	Base period	Adjusted taxable income attributable to base period export gross receipts	Percentage of DISC income deemed distributed	Percentage of total export income deferred from tax
1977	1972-1975	0	50%	25%
1978	1972-1975	0	50%	25%
1979	1972-1975	0	50%	25%
1980	1973-1976	0	50%	25%
1981	1974-1977	17%	59%	21%
1982	1975-1978	34%	67%	17%
1983	1976-1979	50%	75%	13%
1984	1977-1980	67%	84%	8%

E. Use of accumulated DISC income

All of the DISC's income which is not deemed distributed or actually distributed is deferred from tax in the DISC. There is, however, a practical limit to the deferral available, which limit arises from the aforementioned rule that ninety-five per cent of a DISC's gross assets must be Qualified Export Assets. If a DISC runs out of Qualified Export Assets[10] in which to invest its retained earnings, it can retain no more earnings and, therefore, deferral cannot be achieved on future income.[11] The principal asset which a DISC can own is its supplier's accounts receivable from export sales. A buy-sell DISC can also buy its supplier's finished goods inventory which is destined for export and own certain export storage and handling facilities. When it owns all of these assets, the DISC can make loans to its supplier to finance increases in the supplier's export manufacturing capabilities. However, these producers' loans, as they are called, are greatly limited by provisions intended to make sure they are used to increase the manufacturer's export production requirements and not his foreign investments.[12]

F. DISC vs. WHTC

The Code presently contains a special deduction for Western Hemisphere Trade Corporations (special U.S. corporations doing business exclusively in the Americas and the West Indies),[13] but this deduction is being phased out by the Tax Reform Act of 1976.[14] For 1978 this deduction reduces the effective tax rate to forty-three percent; for 1979, to

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10 I.R.C. § 993(b), Treas. Reg. § 1.993-2 (1977).
11 I.R.C. § 992(a)(1)(B), Treas. Reg. § 1.992-1(c) (1974).
12 I.R.C. § 993(d), Treas. Reg. § 1.993-4(a), -(c) (1977).
13 I.R.C. §§ 991-992.
14 I.R.C. § 922(b) (1978).

forty-four percent; and, in 1980, the deduction is completely phased out. In contrast to this diminishing deduction for WHTCs, a DISC can start out with a deduction of the effective tax rate to thirty-four and one-half percent. The remaining eleven and one-half percent is deferred indefinitely.

G. *Future of DISC*

One element of President Carter's tax package is to eliminate DISC benefits over a three year period.[15] The President would phase out new income deferral but would not eliminate deferral on income that is already accumulated in a DISC. It seems there is little support in Congress for this elimination. A Presidential task force on export policy (which included Treasury Secretary Blumenthal) recently suggested other changes.[16] The task force would keep DISC, limit the intercompany pricing method to the four percent method and start a new "World Trade Credit" equal to fifty percent of "incremental export development expenses." The credit would be limited to $100,000 per year and $300,000 over a five year period. No special corporate form would be needed. The credit would be independent of and hopefully simpler than DISC.

II. Licensing

A U.S. corporation often makes its initial contact with overseas markets when it licenses a foreign entity to manufacture, use and sell goods which are the product of a patent or know-how of the U.S. corporation. The foreign entity will pay royalties for use of the know-how, and usually the foreign tax authorities will withhold a tax on the royalty payments. These withholding taxes are often reduced or eliminated by U.S. tax treaties. The royalties are taxable income to the U.S. recipient.[17] The U.S. tax code gives a credit against U.S. tax for foreign taxes paid on foreign source income, such as royalty income from a foreign country.[18]

The foreign tax credit is the U.S. government's way of avoiding double taxation on income. The credit is a dollar-for-dollar reduction of U.S. tax for foreign income taxes paid or accrued by a U.S. taxpayer. However, the amount of credit that may actually be taken in a tax year is the lesser of (1) foreign income taxes paid or accrued during the year, or (2) the amount computed under the following foreign tax credit limitation formula.

$$\frac{\text{Foreign-source taxable income}}{\text{Total taxable income}} \times \text{U.S. income tax before credits} = \text{Foreign tax credit limitation}$$

[15] *See* 14 WEEKLY COMP. OF PRES. DOC. 173 (Jan. 30, 1978); *See also* 14 WEEKLY COMP. OF PRES. DOC. 1633 (Oct. 2, 1978).

[16] *See generally* N.Y. TIMES, May 27, 1978, at 25, col. 6; *id.*, June 27, 1978, § D, at 6, col. 1. *Cf.* LEGAL TIMES OF WASHINGTON, June 26, 1978, at 14.

[17] I.R.C. § 61(a)(6).

[18] I.R.C. § 901(a), (b)(1), Treas. Reg. § 1.901-1(a)(2), T.D. 6789, 1965-1 C.B. 271.

Because of the foreign tax credit, the tax rate resulting from the combined U.S. and foreign income taxes on foreign-source income will be the greater of the U.S. or the foreign rate. If the U.S. tax rate is higher, every dollar of foreign tax paid will reduce the U.S. tax payable, and the two taxes added together will result in a combined tax at the U.S. rate, before credits. If the foreign tax rate is higher, all of the U.S. tax will be eliminated by foreign tax credits and the combined tax rate will be the foreign tax rate. Complications arise if the U.S. and foreign tax authorities differ over the definition of foreign-source income.[19]

As a general rule the foreign tax credit limitation is computed on an aggregate basis, *i.e.*, all foreign taxes and foreign-source income is lumped together for the limitation calculation. If a U.S. company pays foreign taxes which it cannot credit because of the limitation, it can lower its overall tax liability by decreasing the effective foreign tax rate on its foreign-source income, *i.e.*, either decrease the foreign income tax or increase foreign-source income. The mechanics of the foreign tax credit limitation have ramifications throughout this paper, and will be referred to later.

Royalties typically are taxed at a lower rate by foreign tax authorities. Therefore, if there is no other high tax foreign-source income, all foreign taxes paid on royalties are creditable and the combined U.S. and foreign effective tax rate is the same as the U.S. tax rate. For example, assume a U.S. company with $1,000,000 of royalty income from New Zealand. New Zealand will withhold a fifteen percent tax on that royalty, so the U.S. company will receive $850,000. For U.S. tax purposes, the company's gross income from royalties is $1,000,000. Assuming $200,000 of the company's deductions are allocated against foreign-source income, its taxable foreign-source income is $800,000.[20] The U.S. tax before credits is $368,000 ($800,000 × 46% tax rate). Credit is given for the full $150,000 foreign tax paid against the U.S. tax, so the U.S. tax after credits is $218,000 ($368,000 − $150,000). The total tax paid is $368,000 ($150,000 New Zealand tax + $218,000 U.S. tax), and the effective tax rate on the royalty income is 46%, $\frac{(\$368{,}000)}{(\$800{,}000)}$, the same as the U.S. rate before credits.

[19] Nations differ as to what is considered "income" for tax purposes.

[20] Under new regulations of the IRS, for purposes of the foreign tax credit limitation calculation, a portion of the company's deductions must be allocated against foreign-source income. This has the effect of reducing foreign-source income and thereby increasing the effective foreign tax rate. In this example the effective foreign tax rate is increased from fifteen percent $\frac{(\$\ 150{,}000)}{(\$1{,}000{,}000)}$ to nineteen percent $\frac{(\$150{,}000)}{(\$800{,}000)}$. As explained above, the reduction of foreign-source income can result in a foreign tax credit limitation problem. In this example, however, the effective foreign tax rate is still not high enough to cause a problem. Treas. Reg. § 1.861-8, T.D. 7456, 1977-1 C.B. 200.

There are also opportunities for capital gains treatment of royalty income from patents and know-how.[21] In order to attain capital gains treatment, all substantial rights for the useful life of the patent or know-how must be transferred. For a patent, the substantial rights consist primarily of the exclusive right to make, use and sell the patented article, and the useful life is the legal life of the patent (17 years in the U.S.). For know-how, the life is generally indefinite, thus the rights must be given in perpetuity. Generally, the sale of patent and know-how rights can be restricted to use in a single foreign country and still receive capital gains treatment.[22] Capital gains treatment cannot be achieved if a U.S. entity sells the rights to a foreign corporation which it controls.[23] Control generally means ownership of more than fifty percent of the voting power of the foreign corporate stock.[24]

III. Operating Abroad With Own Organization

Exporting and licensing have one great advantage: the headaches and costs of marketing are largely avoided. However, the average American corporation's management wonders whether the distributor or the licensee is making the maximum effort and using the most efficient methods of selling its product. It also wonders how loyal the distributor or licensee is to its product. Generally, a U.S. corporation begins to consider operating abroad on its own when it has been selling goods through unrelated parties to foreign customers for some time and its sales volume has increased to the point where it feels it should have its own people overseas, managing operations and perhaps developing and expanding markets. Another reason for operating abroad occurs when the U.S. corporation has been licensing a foreign entity to use its intangibles, and royalties are increasing to the point where the sales generating the royalties are quite substantial.

A third way of doing business abroad is where the corporation operates through distributors but at the same time has one of its employees located in a central headquarters where the employee can investigate new markets, make deals with new distributors and save the time and expense that top U.S. management officials would otherwise incur in traveling abroad and back. This method overcomes the disadvantages of the first two methods (licensing or selling to a foreign distributor without having an employee overseas). A fourth alternative is for the U.S. company to set up its own sales organization overseas. Finally, a fifth

21 I.R.C. § 1235. Treas. Reg. § 1.1235-1, T.D. 6885, 1966-2 C.B. 307.

22 I.R.C. § 1235(a). Treas. Reg. § 1.1235-2(b)(i) (1977). *See* C.A. Norgren Co. v. U.S., 268 F. Supp. 816 (D.C. Colo. 1967).

23 I.R.C. § 1249.

24 I.R.C. § 1249(b).

method is to set up its own manufacturing and selling operations overseas. It is obvious that under these last three methods (where a U.S. corporation actually goes overseas itself) it will be more complicated to do business overseas, especially if the U.S. corporation sets up its own sales organization and manufacturing operation overseas. The following discussion considers these three methods in relation to foreign and U.S. taxes.

A. Overseas Salesman

Once a U.S. corporation decides to send its own employee overseas, one of the first things it must determine is whether or not it will be considered to be doing business in the foreign country where the employee will be located. If so, the corporation will probably be subject to that country's income tax laws. However, before reaching that conclusion, the corporation must first look to see whether a U.S. tax treaty offers any relief.[25] The U.S. has tax treaties with most of the developed countries but with very few of the less developed countries. Most of these tax treaties provide that commercial profits of a U.S. corporation will not be subject to the income taxes of a foreign country unless the U.S. company has a "permanent establishment" in that treaty country. A "permanent establishment" is generally defined in these treaties to include a sales office with an employee stationed there. However, being subject to another country's tax may not be a great disadvantage since, as previously noted, U.S. income tax may be reduced by any foreign income taxes incurred. There are times, however, when no credit is allowed because of the peculiarities of the U.S. foreign tax credit computation, particularly the limitation. As explained above, if the effective foreign tax rate is higher than the U.S. tax rate, part of the tax will not be creditable.

B. U.S. Corporation vs. Foreign Corporation

If the U.S. business decides to set up a foreign organization, it must decide how to set up overseas; *i.e.*, should it use a branch of the U.S. organization or should it use a separate foreign corporation or even a branch of a separate U.S. corporation? If the U.S. corporation organizes a foreign corporation, the latter's income will usually not be subject to U.S. income tax until a dividend is paid.[26] The opposite is true when a branch of the U.S. company is used to operate overseas; *i.e.*, there will be current U.S. taxation of the branch's earnings. The main tax advantage of selling overseas through a foreign corporation arises when the effective foreign tax rate is lower than the U.S. rate and the earnings are

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[25] *See, e.g.*, Convention on Double Taxation, *entered into force* Dec. 14, 1953, United States-Australia, 4 U.S.T. 2274, T.I.A.S. No. 2880. Convention on Double Taxation, *entered into force* Apr. 1, 1955, United States-Japan, 6 U.S.T. 149, T.I.A.S. No. 3176. Convention on Double Taxation, *signed* Oct. 25, 1956, United States-Austria, 8 U.S.T. 1699, T.I.A.S. No. 3923.

[26] I.R.C. § 61(a)(7). Treas. Reg. § 1.61-9(a), T.D. 6777, 1965-1 C.B. 8.

to be reinvested overseas. In this case the tax on the earnings is deferred and the effective current tax rate is the foreign tax rate. To take advantage of this deferral for financial statement purposes, the company must maintain that it will permanently reinvest the earnings overseas. A branch of the U.S. corporation may be chosen in the initial years of operation because losses incurred by a branch are deductible for U.S. tax purposes.[27] However, if the branch is incorporated overseas when it becomes profitable, the previously deducted losses will probably have to be recaptured.[28]

In transactions involving foreign subsidiaries, it must be remembered that the IRS has the power to allocate income and deductions among related parties if the allocation is necessary either to prevent avoidance of U.S. tax or to clearly reflect the income of any entity.[29] The IRS's position is that all transactions among related parties must meet the standard of arm's-length dealing; that is, the U.S. corporation and its foreign affiliate *must* deal with each other as if they were unrelated. If related parties fail to deal at arm's-length and the result is a reduction of U.S. tax, the IRS will make the necessary allocations to restore the income of each of the parties to what it would have been had the parties dealt at arm's-length.

C. Corporate Income Taxes

With regard to income taxes levied by foreign countries, U.S. businessmen will generally find that in the more developed countries of Western Europe, for instance, the corporate income tax rates approach or even exceed the U.S. corporate income tax rate. Even most of the less developed countries have healthy income tax rates. Some countries (*e.g.*, Ireland) exempt new manufacturing businesses from income taxes. Others, such as Canada and the United Kingdom, offer such incentives as fast write-offs for equipment and buildings. Since these tax holidays and fast write-offs are not recognized for U.S. tax purposes, a foreign subsidiary, and not a branch of a U.S. corporation, must be used to take advantage of the incentives for the reasons explained above.

In general, foreign countries tax the earnings of subsidiaries and branches on an equal basis. However, this is not the case with all foreign countries. For example, West Germany taxes branches at a rate of about fifty percent (not including local taxes). There is a dual rate on corporations. If profits are not distributed, the tax rate is fifty-six percent, but if earnings are distributed, then the corporate tax rate in Germany drops to thirty-six percent. There is also a fifteen percent withholding tax on distributions to the United States. Strictly from the foreign tax aspect, the

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27 I.R.C. § 556(b)(4). Treas. Reg. § 1.556-2(d), T.D. 7207, 1972-2 C.B. 106.

28 I.R.C. § 904(f) as added by the Tax Reform Act of 1976. *See also* Rev. Rul. 78-201.

29 I.R.C. § 482. Treas. Reg. § 1.482-1, T.D. 6952, 1968-1 C.B. 218.

ideal situation in Germany would be to set up a German corporation and distribute as much profit as possible.

In Canada and Mexico it is generally more advantageous to use either a Canadian or Mexican corporation because both Canada and Mexico impose dividend-equivalent taxes. These are taxes to which branches, but not corporations, are subject. A U.S. branch in Canada, for example, pays its regular corporate tax on profits and, on top of that, the branch will pay another fifteen percent nonresident tax on the after-tax earnings. This nonresident tax is equivalent to the dividend withholding tax on dividends that would be paid from a Canadian subsidiary to a U.S. corporation. However, if the business operation were a Canadian corporation, the dividend tax would not be paid until the dividends were actually distributed. Therefore, management would choose a Canadian corporation if it were not going to distribute profits. The same is true in Mexico, because Mexico also imposes a tax on branch profits, whereas a tax on dividends is not imposed until the Mexican corporation actually distributes the dividends.

D. Foreign Indirect Taxes

The typical U.S. company entering the foreign market for the first time will generally sell in the developed countries of Western Europe, namely, the Common Market countries. Here it will find certain indirect taxes not encountered in the United States. On the continent itself, most countries rely on indirect taxes to raise the majority of their revenues. The principal indirect tax is the turnover tax, which is levied by all the Common Market countries. These countries also levy income taxes, but the turnover tax is usually the greater revenue producer. Turnover taxes are similar to our state and local sales taxes. However, turnover taxes are, with very few exceptions, levied on all types of goods and services. The tax is usually passed on to the consumer, so that ultimately the consumer, and not the producer, wholesaler or retailer, bears the burden of the tax. The turnover tax rates vary from country to country; in France the rate is 17.6 percent and in Germany, twelve percent. In the Common Market countries the turnover tax is a value added tax (VAT); *i.e.*, the tax is imposed only on the value that is added at each stage of production and sale. For example, when the wholesaler buys goods for $100 and sells them to the retailer for $150, under the VAT system there is a turnover tax only on the additional $50. Turnover taxes are not creditable.

IV. Tax Havens

The general idea behind the use of a tax haven is to incorporate in a country which does not tax earnings on foreign sales, and to accumulate all income from foreign sales in the company thus incorporated. There are opportunities, as explained above, for deferring U.S. tax on income

from low tax countries because, as a general rule, the United States does not tax earnings of foreign subsidiaries until those earnings are remitted. These opportunities, however, are restricted. First, the IRS will carefully scrutinize dealings between related parties to make sure that income is not being siphoned out of a U.S. company into foreign subsidiaries.[30] As a general rule, the IRS will not allow a foreign affiliate to buy goods at a price less than that which an unrelated party would pay for the same goods in the same circumstances. Second, there are specific rules aimed at precluding use of tax havens by controlled foreign corporations (CFC).[31] If a U.S. manufacturer is using a CFC which was incorporated in a tax haven country to accumulate income from sales to high tax countries (thereby avoiding high tax foreign rates and deferring U.S. tax), the income will be treated as having been currently distributed to the U.S. parent. With some exceptions, investments by a CFC in U.S. property will be treated as dividends to the U.S. parent.

One major exception to these rules applies if the foreign corporation is not controlled by the U.S. corporation, *i.e.*, if the corporation is not a CFC.[32] The test of control is whether the U.S. shareholder owns more than fifty percent of the voting power of the foreign corporation.[33] There are opportunities to divest a company of control, especially if the U.S. company enters into a joint-venture agreement with a foreign entity to sell overseas. The IRS, however, will be quick to attack any artificial structuring arrangements whereby the U.S. company divests itself of paper control but not real control.

V. Middle East Activities

United States companies which have business operations in or related to countries on the Treasury Department's list of boycotting countries (all of which are Arab countries engaged in boycotting Israel) are required to report this fact to the IRS.[34] If the company has agreed to comply with a prohibited international boycott, it is subject to loss, to the extent attibutable to prohibited boycott agreements, of the foreign tax credit, deferral of tax on the income of controlled foreign corporations, and deferral of tax on income from export sales under the DISC provisions.[35] The amount of lost tax benefits can be determined by identifying taxes and income which are specifically attributable to prohibited boycott agreements. Alternatively, the amount of lost tax benefits can be determined by applying the International Boycott Factor[36] to the other-

[30] *See* text accompanying note 29 *supra*.

[31] I.R.C. §§ 951-964. Treas. Reg. §§ 1.951-1.964-1 (1965).

[32] I.R.C. § 951(a)(1).

[33] I.R.C. § 957.

[34] The boycotting countries are Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, Yemen Arab Republic, Peoples Democratic Republic of Yemen. I.R.C. § 999.

[35] I.R.C. § 999(c).

[36] I.R.C. § 999(c)(1).

wise available tax benefits as determined on a worldwide basis. This factor consists of the ratio of sales, purchases and payroll in boycotting countries to worldwide sales, purchases and payroll in activities other than those which are solely domestic in the United States.

Exporters are frequently required to furnish certifications of compliance with prohibited boycott activities in connection with purchase orders and payment of letters of credit. Under current Treasury Department guidelines,[37] furnishing such certifications in response to a purchase order will generally constitute a prohibited agreement.

Most exporters to boycotting countries have been requested to furnish one or more of the following types of certification as a condition for making a sale or receiving payment: (1) that the products as well as the parts or materials have not been manufactured or produced in a boycotted country; (2) that the manufacturer of the product is not on the Arab boycott list; and (3) that the product has not been shipped on a blacklisted vessel or on a vessel owned by a blacklisted person or national or a boycotted country and the shipment has not been insured by a blacklisted company.

Generally, the first type of certification does not constitute compliance with a prohibited boycott as it involves a direct boycott which is excepted from the definition of prohibited boycotts.[38] The second category may be prohibited if it is construed to amount to an agreement not to do business with blacklisted persons.[39] A U.S. manufacturer that exports directly should be able to avoid problems with this type of certification if the certification can be changed to simply name the U.S. manufacturer or a subsidiary as the manufacturer of the product. The final certification will generally constitute compliance with a prohibited boycott. Problems involving this type of certification can usually be avoided by allowing the customer to designate the shipper and insurer, as would occur where the sale is made on F.A.S. terms, so that title to the goods passes to the customer before delivery to the carrier.

Companies which export products to boycotting countries must also be concerned with the 1977 amendments to the Export Administration Act (EAA).[40] These amendments extend the coverage of the EAA to compliance with prohibited boycotts and generally parallel the tax rules in this new coverage. The Act provides for civil and criminal penalties for violations of its requirements, although there are no tax consequences under it. Also parallel to the tax provisions, the Act requires the submission of reports concerning requests to comply with prohibited boycotts and of compliance with such boycotts. These reports must be submitted

[37] 43 Fed. Reg. 3454-470 (1978).

[38] *Id.*

[39] *Id.*

[40] 50 App. U.S.C.A. § 2402 (originally enacted as Export Administration Act, Pub. L. 91-184, Dec. 30, 1969; amended 1977).

to the Department of Commerce, generally within thirty days after a request is received.

The scope of the EAA is somewhat more limited than the tax provisions. It covers only transactions involving U.S. interstate and foreign commerce, and does not affect strictly foreign activities of foreign subsidiaries. On the other hand, the EAA prohibits certain types of activities that are not specifically covered by the tax rules, particularly in areas related to the furnishing of information concerning business relationships with blacklisted persons and boycotted countries and their nationals.

Question and Answer

Question: Where you have both consulting services and licensing, trademarks or goodwill, should the attorney draft separate agreements for tax purposes?

Mr. Henning: Generally, the answer is yes. It is generally true that foreign countries tax trademark, licensing and know-how agreements differently than they tax income from consulting services. In fact, in the consulting service area, if the service is going to be performed partly in the United States and partly in the foreign country, I would suggest a third agreement to breakdown existing agreements. This breakdown should specify what payment was for services in the foreign country and what payment was for services in the United States. Beyond taxation purposes, I think this procedure is good for exchange control reasons. In foreign countries there may be completely different rules for repatriating money earned on a consulting fee rather than on a licensing fee.

Question: Is there any way a DISC can use its money to acquire a portion of the parent's plant or equipment that is used exclusively to manufacture products for export?

Mr. Henning: The DISC cannot manufacture, therefore it cannot own any manufacturing assets. However, I mentioned the so-called producer loan in my speech. That is geared for this situation. It allows the DISC to make interest bearing loans back to the parent company provided the parent increases its property, plant equipment, research and development and inventory, measured from the beginning to the end of the year. A bonded warehouse that is used exclusively for goods to be exported can be owned by a buy-sell DISC. I have a couple of clients who, in fact, own one of these warehouses with export inventory in it.

Question: Please comment on the level of sales which makes a DISC useful.

Mr. Henning: On the problem of when a DISC becomes useful, I would like to comment that it is true that the DISC is complex, but now that we've had about six years of experience with DISC, I would not defer setting up a DISC simply because of the complexity. I think the people who practice in the area now know what the rules are. As to

whether one should establish a DISC, I would consider levels of profit as a consideration. If you are only making $20,000 on your exports, obviously that is probably not enough, but if you are making around $100,000 profits, I would get in the game. Let's face it, it's a tax free loan, the same as fast write-off depreciation.

Question: Are there any tax advantages of operating in Puerto Rico?

Mr. Henning: Yes, there are very significant operational advantages if you can qualify for a tax holiday in Puerto Rico. My first concern would be whether it is economically feasible. There are labor problems and unemployment in Puerto Rico. However, assuming you can make your product effectively down there, the Puerto Rican government will give you a fifteen year tax holiday for manufacturing there. It is not a complete tax holiday. Puerto Rico changed their legislation at the end of June 1978. You can only get a maximum tax holiday on ninety percent of your profits and that varies, depending on where you put your operation on the island.

In addition, the United States has the so-called Possessions Corporation in section 936 of the Internal Revenue Code. A corporation which qualifies under this section is not taxable on the profits it earns in Puerto Rico, nor are its dividends taxable when paid to the United States. The only tax you will pay on operations in Puerto Rico is a minimum Puerto Rican tax with respect to the venture. It may be roughly ten percent.

There is a caveat to these advantages, however. As I pointed out earlier, labor used to be cheap and that was the reason many corporations built facilities there. Recently prices have gone up significantly, and now there is a shortage of skilled labor. It is questionable whether you can justify the move from an economic point of view. Nevertheless, if you can justify it economically, the tax benefits are there.