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Tax Considerations of the International Business Venture

by Richard M. Hammer*

This article will summarize, for purposes of recognition and awareness, certain key tax concepts that affect U.S. corporations doing business abroad. An understanding and appreciation of these concepts are essential in developing a tax strategy for overseas operations.¹

I. Basic Framework of U.S. Tax System—Treatment of Foreign Income

A. *The Global System of Taxation*

Since the inception of its tax law, the United States has subscribed to the global system of taxation, rather than the alternative territorial system. Under the global approach, the worldwide income of a U.S. corporation, a U.S. citizen or a U.S. resident alien is fully subject to U.S. tax, unless a specific statutory exemption or exclusion applies. In contrast to this worldwide system, certain countries, such as France and the Netherlands, apply the territorial approach. Under this approach, only income arising from domestic activities and from foreign portfolio investments is subject to home country taxation. In other words, income from direct investment abroad is exempt from local income tax. In countries employing the territorial system, the principal concern, from a policy point of view, is to properly identify income from direct investment abroad which will enjoy the exemption privilege. This is necessary to avoid abuse.

Under a global system like that of the United States, international double taxation is avoided by means of a foreign tax credit mechanism; rather than exempting foreign direct investment income, a direct offset

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¹ The conference held October 31, 1980 focused primarily on the various legal considerations applicable to the U.S. businessman involved in foreign markets and operations. Accordingly, this article addresses only those tax rules pertinent to the U.S. businessman engaged in capital exporting. Tax considerations applicable to capital imported into the United States are not addressed, however. For a detailed discussion of the U.S. tax treatment of inflowing investment, see generally R. HAMMER, *GENERAL TAX RULES AND PLANNING FOR UNITED STATES OPERATIONS* (1978); R. HAMMER, *U.S. TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS* (1975).

against the home country tax on foreign income is allowed for the tax levied in the source country.

B. The Deferral Issue

Where a global system is in effect, one of the two major policy issues involved is the question of whether to tax currently the income earned by foreign corporations controlled by U.S. taxpayers, or to defer U.S. taxation of the income of these overseas affiliates until such income is repatriated to the U.S. shareholders. Where a U.S. corporation establishes a division or branch abroad, the foreign branch income will be subject to current U.S. taxation. Some would assert that the income of a foreign subsidiary should be treated likewise, rather than being deferred from U.S. tax until repatriation. The guiding principle is, of course, that the United States has no legal right to assert tax jurisdiction over the non-U.S. income of foreign corporations which are, in effect, citizens of another country. But, more importantly, it seems clear that Congress did not wish to place U.S. corporations at a competitive disadvantage by taxing currently the income of a U.S. controlled foreign subsidiary to its U.S. parent, while corporations domiciled elsewhere were not subject to such taxation. The U.S. Congress has, however, through the enactment of certain provisions in the Internal Revenue Code,² terminated deferral for certain specified categories of tax haven income earned by controlled foreign subsidiaries.³

C. Foreign Tax Credit

The second major policy consideration in a global system is the proper structuring of the foreign tax credit. This is of paramount importance because it is the primary weapon in such a system for the avoidance of international double taxation, which generally arises where the country in which business activities are conducted and the home country tax the same income. The U.S. statute allows a foreign tax credit against U.S. income taxes,⁴ limited to the amount of U.S. tax otherwise payable on foreign source taxable income. The purpose of the limitation is to prevent the credit from spilling over against the U.S. tax on domestic income. Most U.S. taxpayers are concerned with two particular problems: a shrinking of their foreign tax credit limitation, primarily by reason of a relatively new regulation on allocating and apportioning de-

² See notes 21-25 and accompanying text *infra*.

³ The deferral concept is inherent in the tax law and is not a specific statutory provision. Thus Subpart F, which encompasses Sections 951-964 of the Code, mandates current taxation of tax haven income earned through U.S. controlled foreign corporations (CFCs). In 1978, the Carter Administration proposed amending the tax law to provide current taxation of all income earned by CFCs, not just the specified tax haven income, but this proposal did not impress the Congress and languished.

⁴ I.R.C. §§ 901-907.

ductions to foreign source income⁵ and a shrinking of their foreign taxes available for credit, by reason of a restrictive set of proposed regulations issued by the IRS with the goal of greatly limiting the types of foreign taxes which qualify as creditable foreign income taxes.⁶

II. Portfolio Investment

Although the main thrust of this article concerns overseas business activities and corporate direct investment abroad, it seems appropriate to mention briefly portfolio investment, which U.S. multinational corporations engage in from time to time. Although there is no precise definition of portfolio investment, in tax parlance the term generally connotes, in addition to investment by individuals, investment by corporations in other corporations (share or securities) in which the equity ownership held by the investing corporation in the investee corporation is less than ten percent. In other words, a ten percent or more equity participation by one corporation in another makes the two corporations affiliates, and makes the investment a direct investment.

The tax rules surrounding portfolio investment abroad by U.S. corporations are not overly complex. If the U.S. corporation itself makes the investment, the income derived therefrom is fully subjected to U.S. taxation. If it has been taxed in the source country, usually by means of a foreign withholding tax levied and collected at source, the U.S. corporation will obtain the foreign tax credit relief for this tax.⁷

United States corporations have sometimes made their overseas portfolio investments through foreign affiliates, generally created under the laws of an appropriate tax haven. The income derived by the tax haven investment corporation from such investments is imputed back and currently taxed to the U.S. corporation, under either the foreign personal holding company⁸ (FPHC) or the Subpart F/controlled foreign corporation (Subpart F/CFC) provisions.⁹ Both of these sets of anti-avoidance provisions in the Code operate to pierce the corporate veil in certain situations and tax the income as if directly earned by the shareholder.

The Subpart F/CFC provisions are discussed below.¹⁰ The FPHC provisions only apply where the ultimate U.S. shareholders of the U.S. parent are a small group of persons or a family group, for example where the statute specifies ownership of "more than 50 percent in value . . . by or for not more than *five* individuals who are [U.S.] citizens or residents,"¹¹

⁵ Treas. Reg. § 1.861-8(f) (1977) (effective for years beginning on or after January 1, 1977).

⁶ Proposed Treas. Reg. §§ 1.901-2, 1.903-1 (1979). A set of repropoed regulations to soften the harsh impact of this proposed set of regulations was promised by the IRS and Treasury for early issuance in December 1979, but has not appeared as of the date of this writing.

⁷ See notes 30-33 and accompanying text *infra*.

⁸ I.R.C. §§ 551-558.

⁹ *Id.* §§ 951-964.

¹⁰ See notes 21-25 and accompanying text *infra*.

¹¹ I.R.C. § 552(a)(2) (emphasis added).

considering certain attribution or constructive ownership rules. Thus, the publicly owned U.S. corporation does not concern itself with the FPHC rules but is very much concerned with the Subpart F rules which are *not* limited in application to only closely held corporate situations.

III. Exports—DISCs

Before exploring the general tax consequences of a U.S. enterprise actually conducting activities in a foreign country, which often will involve establishing overseas facilities, the subjects of exporting and licensing should be treated. Exporting is one possible means for U.S. companies to exploit overseas market potential, without necessarily involving large overseas capital outlays or commitments. Many U.S. companies enter international trade and business for the first time via the export route. It was not until 1971, however, that the Congress perceived a need to increase U.S. export activities through the tax system, for the encouragement and enhancement of domestic productive activities. It was at that time that the Domestic International Sales Corporation (DISC) provisions were enacted, effective first for 1972.¹²

The principal feature of the DISC provisions is that some portion of the export related profits will not be subjected to federal income tax until actually or constructively distributed by the company earning them, the DISC. There are two types of DISCs, a buy/sell DISC and the more widely used commission DISC.¹³ A buy/sell DISC receives orders directly from its customers, takes title to export goods for resale abroad, issues invoices in its own name, and collects accounts receivable from its customers. A commission DISC earns a commission, generally from participating in the export sale of its related supplier (usually the parent or a sister company), with the supplier continuing to perform all export functions.¹⁴ Ordinarily, the DISC will earn a commission equal to the maximum profit, calculated under a set of special safe haven intercompany pricing rules, that it would be entitled to if it were a buy/sell DISC. The regulations require that the related supplier must actually pay the commission within sixty days after the close of the DISC's year.¹⁵

To obtain the DISC benefits, a non-manufacturing domestic corporation, engaged solely in export activities, must elect to be treated as a DISC. There are a number of requirements to be met to qualify, the most important of which are these:

1. *Gross receipts requirement.*—For each year, a DISC must derive at least ninety-five percent of its gross receipts from the sale or lease of ex-

¹² Pub. L. No. 92-178, § 501, 85 Stat. 535 (I.R.C. §§ 991-997).

¹³ See I.R.C. § 992(a), (c).

¹⁴ A DISC can, however, be independent and be used to distribute U.S. manufactured products of unrelated manufacturers.

¹⁵ Treas. Reg. § 1-994-1(c)(3)(i) (1975).

port products manufactured in the United States or commissions from such export transactions. Also, certain specified types of interest income will qualify.¹⁶

2. *Asset requirement.*—To maintain DISC qualification, ninety-five percent of the corporation's total assets at each year-end must consist of export inventories, assets used primarily in connection with sale or lease of export inventories, accounts receivable, and evidences of indebtedness arising in connection with export transactions.¹⁷

A DISC itself is not subject to federal income tax. Rather, DISC income is taxed in the hands of its shareholders as a dividend when: (1) there is an actual distribution of DISC income; (2) there is a deemed distribution of DISC income; (3) DISC status is terminated, or when a shareholder sells his DISC stock and the gain realized reflects his share of untaxed DISC income; or (4) the DISC pays any foreign bribe or participates in an international boycott.¹⁸

IV. Licensing

When exporting begins to prove an unwieldy or uneconomical way to supply products to foreign markets or, perhaps more importantly, begins to prove noncompetitive, another way to exploit foreign markets must be found. Some form of local overseas manufacturing is required. The simplest and perhaps most inexpensive way to accomplish this objective is to license an unrelated foreign company to manufacture the U.S. company's product line. A license arrangement of this standard variety typically entails making available some of the U.S. company's intangible property rights, such as patents, trademarks, processes, and know-how, to the foreign licensee in exchange for a royalty interest. This is a relatively straightforward arrangement, although the U.S. company must ensure that maximum legal protection under the relevant local law has been obtained.

Tax issues are of little complexity in a licensing arrangement. The U.S. licensor will generally not carry on enough activities in the licensee's country to be subjected to ordinary income taxation there, generally determined by applying the relevant corporate rates to the corporation's net income. Instead, the licensor is taxed at a flat rate on the gross amount of the royalty income, as paid, without deductions. The tax is generally withheld at the source by the payor. The rates vary from country to country, but generally fall in the twenty-five percent to thirty-five

¹⁶ I.R.C. § 992(a)(1)(A).

¹⁷ *Id.* § 992(a)(1)(B).

¹⁸ *Id.* § 995. I.R.C. § 999 specifies under what circumstances U.S. taxpayers, their DISC's, or their controlled foreign corporations will be treated as participating in an international boycott.

percent range, although they can be reduced where tax treaties exist.¹⁹ On the other side of the transaction, the unrelated licensee is generally entitled to an ordinary income deduction, for purposes of its home country income tax, for the royalty payment.

Over the years, various methods have been devised for effecting a sale, rather than a license, of intangible property rights, so as to have the U.S. owner of the intangible property derive capital gain, which, under the Internal Revenue Code, is taxable at a preferential rate, currently twenty-eight percent for corporations.²⁰ Generally, this has been accomplished, not without challenge, by carving out a special geographic area (*e.g.*, for each foreign country in which it is to be exploited) and selling to the foreign buyer in each such country all the rights in the property applicable to that area.

V. Use of Branch of U.S. Corporation Abroad Rather Than Local (Foreign) Subsidiary

In due course, the U.S. enterprise may find that licensing is not the most profitable manner in which to exploit foreign markets, by reason of the lack of an equity participation. At that point, the U.S. enterprise may wish to establish its own overseas activities. In setting up foreign operations, or even expanding into new territories by a mature multinational, a U.S. enterprise has the choice (1) to operate in foreign areas as a branch or division of the U.S. parent, (2) to operate as a branch of a separate U.S. subsidiary of the parent, usually employed to limit legal liability to assets in the foreign branch operation, or (3) to incorporate a local (foreign) subsidiary. For both tax and non-tax reasons, U.S. companies do not always choose the same option; it depends upon both the individual facts and circumstances of each company and the relevant underlying business philosophy.

If the choice is made to establish a local branch of either the U.S. parent or another U.S. affiliate in the U.S. group, it must be emphasized that, legally, the new foreign operation is merely an extension of a U.S. entity, not a new and separate local legal entity. The U.S. tax treatment, as well as that of most other countries, recognizes this principle. Thus, in start-up situations, the normally expected start-up losses will offer a U.S. tax benefit by constituting a valid deduction by the U.S. group, probably in a consolidated return,²¹ against the other group income, whatever the nature or source.

This deduction has long been one of the traditional tax benefits in embarking on operations in a particular foreign country or area of the world, to be followed later, perhaps when the turnaround point arrives,

¹⁹ Many treaties reduce the withholding tax on royalty income to zero, and others reduce it to the ten percent range.

²⁰ I.R.C. § 1201(a)(2).

²¹ See *Id.* §§ 1501-1505; Treas. Reg. §§ 1-1501 to 1-1504 (1966).

by a local incorporation of the branch operation, since when the branch begins to produce profits, such profits are immediately taxable in the United States. Accordingly, out of the basic principle that a branch represents an extension of the U.S. entity of which it is a part comes the basic rule allowing immediate recognition of losses incurred, as well as current taxation of income earned, by an overseas branch.

There are a number of disadvantages, both tax and non-tax, to using a branch for overseas operations, in addition to immediate U.S. taxation of its profits. For example, acceptance of the U.S. presence in a local economic environment by the local citizenry and government officials is often facilitated by using a local subsidiary. This is undoubtedly the major non-tax disincentive for use of a foreign branch. On the tax side, all countries subject local branches of foreign enterprises to their regular corporation income tax; in addition, many countries impose an additional branch tax each year, which serves as compensation for the fact that such operations generally avoid dividend withholding taxes. A dividend withholding tax is controllable through monitoring the dividend flow and thus deferring the tax. The branch tax is levied annually and thus, despite the U.S. foreign tax credit relief, often constitutes, in whole or in part, an additional current, nondeferrable cost of doing business. Canada, France, and Belgium are examples of countries imposing branch taxes.²² Other countries, such as the United Kingdom, do not impose this tax.

Additionally, in recent years the United States has imposed a harsh set of recapture rules which severely limits the benefit of using a branch abroad, particularly if the principal reason for its use is to absorb start-up losses for U.S. tax purposes. These recapture rules are extremely detailed and technical, but can be summarized as follows: First, upon a subsequent local incorporation of a foreign branch, a transaction which generally requires an IRS ruling, the IRS will, in consideration of a favorable ruling, require recapture of the net amount of losses previously deducted by the taxpayer.²³ Second, new rules enacted in the 1976 Tax Reform Act require a taxpayer who suffered overall foreign losses in prior years to reduce its otherwise allowable foreign tax credit until the previous losses are fully recaptured.²⁴ In addition to these relatively new recapture concepts, a current loss in a foreign branch has the potential to reduce the taxpayer's foreign tax credit under the mandatory overall

²² Most notable among the countries which impose this branch tax is Canada, where such tax is statutorily twenty-five percent, reduced to fifteen percent under the present tax treaty. *See* Income Tax Treaty Between Canada and the United States, Jan. 1, 1941, art. XI, 56 Stat. 1399, T.S. No. 983. Under a new tax agreement with Canada which is not yet in force, this tax is to be reduced further to ten percent. Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States-Canada, art. X, para. 6, *reprinted in* [1980] 1 TAX TREATIES (CCH) ¶ 1310.

²³ *See* I.R.C. § 367; Temp. Treas. Reg. § 7-367 (1977). Rev. Rul. 78-201, 1978-1 C.B. 91 has clearly spelled out the IRS position regarding the loss recapture concept.

²⁴ I.R.C. § 904(f).

foreign tax credit limitation formula, discussed below.²⁵

VI. Foreign Subsidiary in Country or Region in which Operations are Conducted

The second option for a U.S. enterprise contemplating overseas operations is a subsidiary, incorporated in the country in which its business activities, in whole or in part, are to be conducted. If the U.S. company conducts its overseas operations through a foreign subsidiary company, that subsidiary's income is normally not subject to U.S. tax until distributed as a dividend to the U.S. parent. This is what was referred to previously as tax "deferral," since the parent company is considered to be in a position to defer the payment of U.S. tax on such income until received as dividends. It is important to note, however, that the foreign subsidiary generally pays income and other taxes in the country where it is incorporated and/or where its operations are conducted. Local tax burdens are often equal to or higher than the U.S. burden. If, in fact, the foreign income tax bite is equal to or higher than the U.S. tax, it is likely that no U.S. tax will be paid on that income, by virtue of the foreign tax credit relief mechanism. On the other hand, if the foreign income taxes are lower than the U.S. tax, some additional U.S. tax will be payable when the foreign income is distributed in dividend form to the parent. Only in this latter situation is there any real deferral of U.S. taxes, the earnings being retained by the overseas enterprise and reinvested. Income can also be repatriated from foreign affiliates or subsidiaries through interest payments, royalties, and fees, the receipt of accrual of which, like dividend receipts, constitute taxable income to the U.S. parent. In these cases, however, unlike dividends, the payments are generally tax deductible in the payor's country. Any withholding taxes paid on these other items of income are also available for the foreign tax credit, but only dividends give rise to the so-called "deemed paid" (indirect) credit. The deemed paid credit is the credit for taxes paid by the foreign entity on the income out of which the dividends flow.²⁶

It should also be noted that any losses incurred in an incorporated foreign operation do not flow through to the U.S. corporation and are only available for tax benefit in the country of incorporation, depending upon the net operating loss carryover rules in that country. Most countries, like the United States, do permit loss carryovers to profit years, but the basic rules and carryover periods vary from country to country.

A foreign subsidiary, therefore, can generally use its earnings for local expansion, without first repatriating them to the United States in the form of taxable dividends. Presently, instead of an overseas corporate structure with a tax haven holding company at its apex, the more typical pattern is for U.S. multinationals to own directly the shares of each for-

²⁵ See notes 33-37 and accompanying text *infra*.

²⁶ *Id.*

eign operating subsidiary. Nevertheless, in some cases, the use of a holding company can result in the reduction of foreign withholding taxes, mainly through the operation of tax treaties and there is still a limited amount of interest in holding companies as U.S. multinationals seek to reduce their overall effective tax rates.²⁷

A key reason for incorporation of a local entity, as already noted, is to "perfect the image" of the U.S. enterprise as a local citizen, and this factor is extremely important, particularly now that the newer United States rules have removed most of the benefit of using branches to absorb start-up losses for tax purposes.

One additional point might be noted. When the U.S. company chooses to "cash out" of the foreign subsidiary by selling its shares, assuming that it is a controlled foreign corporation—more than fifty percent U.S. owned in terms of voting power—and that the selling shareholder owns at least ten percent of the voting power, the realized gain is treated as dividend income, rather than a capital gain, to the extent that the controlled foreign corporation's post-1962 earnings are attributable to the selling shareholders.²⁸ A foreign tax credit (deemed paid credit) is available, however, for the income taxes paid by the subsidiary on the earnings out of which the deemed dividend is constructed.²⁹ This rule, enacted in 1962 as a penalty provision, has indeed turned out to be beneficial in many cases, since a capital gain incident to this type of transaction does not give rise to the deemed paid foreign tax credit. Thus, unless the income tax borne by the overseas subsidiary was relatively low, the net U.S. tax burden calculated under the dividend treatment generally amounts to less than the capital gain tax otherwise would have been. In the case of liquidation of an eighty percent or more owned subsidiary, the above rules apply, except that there is no December 31, 1962 cut-off;³⁰ liquidations of less than eighty percent owned subsidiaries follow the general rule.

VII. Offshore Foreign Subsidiary in Tax Haven Countries

A. Generally

Since tax rates and source rules vary considerably from country to country, the U.S. corporation planning an overseas operation may have considerable flexibility in the matter of location, place of incorporation, and method of operation. If the overseas operation is complex and involves a number of activities, such as exporting from the United States,

²⁷ The use of a holding company to reduce withholding taxes depends upon the particular countries involved and the relevant bilateral tax treaties. Many multinationals use the Netherlands as a situs for a holding company, particularly for European operations, because the Netherlands has both a very favorable treaty network and a favorable tax regime for holding companies.

²⁸ I.R.C. § 1248(c)(2).

²⁹ *Id.* § 1248(c).

³⁰ *See id.* § 367; Temp. Treas. Reg. § 7.367(b)-5 (1977).

overseas manufacturing, sales in a number of countries, licensing arrangements, or group financing arrangements, it may be desirable to incorporate and use a number of foreign corporations, including, in the appropriate circumstances, holding companies or based companies. In this area, management must be aware that the U.S. tax rules since 1962, when the Subpart F (controlled foreign corporation) provisions were added to the Code, have made careful planning essential to avoid unwelcome surprises.

B. Subpart F

At this point, it is appropriate to provide a brief discussion of the Subpart F rules, which are quite detailed and complex.³¹ In essence, Subpart F requires the inclusion in a U.S. taxpayer's income of certain items of income earned by controlled overseas subsidiaries (those more than fifty percent owned by U.S. shareholders), whether or not paid out as a dividend. In effect, these rules constitute a partial termination of deferral. The income items involved include passive, investment-type income and certain trading and service income which is earned through tax haven subsidiaries and thus bears little, if any, foreign income tax, with some very well defined exceptions and exclusions.³² The following items are of interest in evaluating the operation of the Subpart F rules in today's tax environment.

1. *Source of Additional Foreign Income.*—Many U.S. multinationals are finding increasing pressure on their foreign tax credit limitation due to many factors, including increasing foreign tax burdens and the 1977 U.S. allocation and apportionment regulations.³³ Accordingly, the deliberate creation of Subpart F income has become a valid planning technique by providing a source of additional foreign income against which to claim credit for ever increasing amounts of excess foreign tax credits. Thus, what was enacted as a penalty provision has become useful in some cases.

2. *Central Financing.*—Central financing of foreign operations for an international group seems to have become an increasingly popular phenomenon, probably because of the economics of scale in effecting all external group borrowings through one entity with one or more large financial institutions, rather than having each local affiliate borrowing in its local country.

To accomplish its central financing objective, a U.S. controlled group could use a wholly-owned Dutch finance subsidiary to borrow from banks in order to relend to the other group members. The plan can

³¹ I.R.C. §§ 951-964.

³² *Id.* § 954.

³³ Treas. Reg. § 1.861-8 (1977).

be summarized by the following sequence. First, the Dutch will allow the local subsidiary to reflect annual taxable income equal to 1/4% to 1/8% of the principal amount of the loan. In effect, this means that the Dutch financing subsidiary has to mark up the outside bank's lending rate by this small percentage for establishing its interest rate to borrowing affiliates. This spread then represents the finance company's taxable income, subject to a Dutch forty-eight percent corporate tax rate. Second, the comprehensive Dutch tax treaty network provides for zero withholding tax in most countries in which borrowing affiliates would be located. Third, the Dutch internal law imposes no withholding tax on interest payments to nonresidents. Finally, although the income constitutes Subpart F income for U.S. purposes, the Dutch tax will offset, by means of the foreign tax credit, the U.S. tax on the Subpart F income involved; and generally the IRS has, thus far in our experience, accepted the spread required by Dutch practice, without attempting to increase it. It should be emphasized that this arrangement is not a tax saving device, but a means to economize an outside financing for a multinational group.

3. *Dutch Holding Company*.—A Dutch holding company owning shares in certain other affiliates can reduce overall withholding tax burdens. For example, in Belgium, the withholding tax rate on dividends to a U.S. parent is fifteen percent.³⁴ If Belgian dividends are routed to the United States through a Dutch holding company, the rate is cut to 9 3/4% (5% from Belgium to the Netherlands³⁵ and another 5% from the Netherlands to the United States).³⁶

VIII. Joint Ventures

One of the more popular approaches used today by U.S. corporations investing in business operations in particular foreign countries is through joint ventures with local enterprises in those countries. There are a number of reasons, both non-tax as well as tax, which attract U.S. direct investors to the joint venture form. In summary, these advantages are as follows.

A. Non-Tax

1. *Reduced Amount of Capital*.—It reduces the amount of capital that the U.S. investor must raise for the project, since a local partner is sharing in the capital requirements as well as the fruits of the new business;

³⁴ Double Taxation Convention, July 9, 1970, United States-Belgium, 23 U.S.T. 2690, 2697, T.I.A.S. No. 7463.

³⁵ Convention for the Avoidance of Double Taxation with Respect to Taxes on Capital, September 25, 1948, Belgium-Netherlands, art. 2, 123 U.N.T.S. 82, 84-85.

³⁶ Convention with Respect to Taxes on Income, April 29, 1948, United States-Netherlands, art. VII, 62 Stat. 1757, T.I.A.S. No. 1855, as amended by Supplementary Convention, Dec. 30, 1965, art. V, 17 U.S.T. 896, 900-01, T.I.A.S. No. 6051.

2. *Know-How and Management Skills*.—If the proper local partner is selected, the joint venture form provides the new business with important local marketing know-how as well as local management skills;

3. *Substantial Local Participation*.—Many countries, notably in Latin America, require by law a substantial (often majority) local participation in any local business operation; joint venture arrangements satisfy the rules and regulations of these countries.

B. Tax

1. *Subpart F Avoidable if Disadvantageous*.—The Subpart F provisions, if perceived as disadvantageous in the particular circumstances, can be avoided where the foreign partner owns at least half of the voting power;

2. *Retention of Capital Gains*.—The capital gain treatment of a potential "cash out" can be retained, when advantageous, if the foreign partner owns at least half of the voting power;

3. *True Joint Ventures*.—A true joint venture (*i.e.*, where the venturers are two or more unrelated persons) reduces the likelihood of a challenge by any fiscal authority as to the arm's length nature of any commercial or financial arrangements between the venture and either venturer or affiliates of either venturer.

IX. Capitalization of Foreign Affiliates

The composition of the capital structure of overseas subsidiaries, particularly as between debt and equity, is a very important consideration in planning overseas operations through foreign subsidiaries. It may often be advantageous to structure as much of the capital investment as possible in the form of debt, rather than equity. There are two advantages to this type of approach. First, interest payments on a bona fide indebtedness are tax deductible in virtually every foreign country. Conversely, if the capital invested is classified as equity capital, the return must emanate from after-tax earnings in the form of nondeductible dividends. Second, there is no tax consequence to either the debtor or creditor on the repayment of debt, although it should be noted that repayments of debt must come from after-tax earnings. Conversely, repayment of capital is generally regarded as a dividend to the shareholder, to the extent of earnings.

The IRS closely scrutinizes debt arrangements between a U.S. parent and its overseas subsidiaries to satisfy itself that any debt between them is, in its view, debt rather than equity. The primary disadvantage of such an IRS assertion, if sustained, would be the treatment of the repayments of debt to a U.S. parent as a taxable dividend. In the United

States, unlike other countries, legal form is often disregarded in tax matters, with the substance of the transaction governing its tax treatment. Thus, the mere act of labeling an instrument as a debt instrument is not sufficient to ensure its treatment as debt for U.S. tax purposes. It might also be noted that certain other countries are beginning to adopt similar thin capitalization rules and concepts.³⁷

The key factor in distinguishing a debt instrument from an equity investment is the intention of the parties at the time of the original transaction. Since intent is entirely subjective, the determination of intent must be made by reference to all the facts and circumstances. For this reason, there is a plethora of case law on the issue. A substantial number of these cases have been resolved in favor of the taxpayer's claim that the investment is debt rather than equity. On the other hand, the only statutory authority on the question is section 385 of the Code which was enacted in 1969. Regulations interpreting section 385 have recently been promulgated.³⁸

X. Transactions Between Offshore Affiliates and U.S. Affiliates

Although the U.S. rules governing intercompany transactions and profit allocations apply to any dealings between related parties, it is the relationships between U.S. entities and their overseas affiliates which receive the most attention from IRS examiners. The statutory authority governing related party transactions in section 482 of the Code, which permits the IRS to reallocate income and deductions between or among related entities where necessary to reflect the true income of a U.S. taxpayer.

Under the authority of section 482, as well as the detailed regulations thereunder,³⁹ IRS agents will examine closely the books and records of U.S. corporations and their foreign affiliates to ensure that, in their view, the U.S. corporation is not absorbing expenses more properly allocable to a foreign affiliate, or charging unrealistically low sales prices to overseas affiliates. Thus, a U.S. corporation engaged in foreign operations through subsidiaries abroad should be prepared to justify its intercompany pricing and charge practices and should keep adequate records in support of its position.

The concept that a U.S. taxpayer should deal with affiliates on an arm's length basis is fundamental in this area. U.S. tax regulations pro-

³⁷ Canadian law provides that to the extent debt to a related party exceeds the equity by 3 to 1, the excess will not be regarded as debt. Income Tax Amendments Act, 1971, Can. Stat. c. 16, § 15(3). Germany proposed legislation in 1980 which would impose a more restrictive debt/equity ratio, but such law has not yet been enacted.

³⁸ Proposed Treas. Reg. §§ 1.385-1 to -12 (1980). These proposals were promulgated on March 24, 1980. A final version of the regulations was issued on December 29, 1980 and is scheduled to become effective on May 1, 1981.

³⁹ I.R.C. § 482 is a brief statutory provision, providing broad reallocation powers to the I.R.S. in intercompany transactions. For the essential elements of the I.R.S. approach, and the implementational details, see Treas. Reg. §§ 1.482-1 to -2 (1968).

vide guidelines concerning how related taxpayers should deal with each other and, in a number of instances, these regulations also provide exceptions to the arm's length standard in the form of safe havens or formula approaches. The importance of these rules cannot be over emphasized. If U.S. multinationals fail to take adequate heed of these principles by proper advance planning and structuring of their intercorporate arrangements, the IRS will almost certainly propose and sustain adjustments, often of material amount, which can cause complete disruption of intercompany dealings. Not only does this impose a perhaps unforeseen additional tax cost but it also will have an adverse effect on financial statements because such additional taxes must be provided for in the accounts.

Moreover, intercompany transfer pricing adjustments, effected by IRS after the fact, are seldom recoverable through the tax system of the company in which the foreign affiliate is a taxpayer other than through the cumbersome and protracted mutual agreement/competent authority mechanism of our tax treaties. Furthermore, this mechanism is not guaranteed effective and, of course, it is inapplicable in countries with which we have no tax treaties.

It is important to be aware that although the United States assumed the lead in rigorously scrutinizing intercompany transactions, other countries have in recent years undertaken similar programs. Thus, lack of attention to the proper structuring of intercorporate arrangements can give rise to proposed deficiency assessments from the revenue authorities of other countries, as well as from the United States.

Of particular concern today to the tax authorities of developed countries are those situations in which a tax haven affiliate is conducting transactions with a local affiliate. These situations are particularly prone to close scrutiny and should thus be structured with extreme care toward maximizing the arm's length nature (with appropriate support and documentation) of the relevant intercompany transactions.

XI. Maximizing Relief From Double Taxation

A. Treaties

A most significant concern for all internationally oriented U.S. enterprises is the avoidance of international double taxation; in other words, maximum utilization of the tools designed to provide taxpayers with relief from double taxation should be adequately considered in planning foreign operations.

The first such tool is the use of tax treaties,⁴⁰ bilateral agreements between two nations with the avowed aim of eliminating double taxation

⁴⁰ See Organization for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, [1980] 1 TAX TREATIES (CCH) ¶ 151; U.S. Treasury Department Model Income Tax Treaty, May 17, 1977, [1977] 1 TAX TREATIES (CCH) ¶ 153.

on crossborder transactions and operations. Thus, a U.S. multinational with a German subsidiary will obtain an exemption from German tax on the receipt of interest or royalty payments from the German subsidiary and will pay a reduced rate of German tax of fifteen percent on dividends received from the German affiliate.

This is the direct use of tax treaties. In some cases, however, it may be important to take advantage of third country treaties. For example, as mentioned above, U.S. investment in Belgium can be channeled through the Netherlands to reduce total dividend withholding taxes from fifteen percent to something less than ten percent.⁴¹

B. Foreign Tax Credit

1. *Background.*—Although treaties are significant, the major protection from international double taxation for U.S. corporations has been, over a lengthy period, the U.S. foreign tax credit mechanism, a unilateral form of relief offered by the Internal Revenue Code to U.S. taxpayers.⁴² It should be noted that the U.S. version (many other countries have a comparable mechanism) has worked quite well.

The purpose of providing a credit against the U.S. tax for foreign income taxes is to ensure that profits earned overseas are not subject to the full impact of two countries' income tax systems. In general, the United States relinquishes its tax on income earned abroad up to the amount of the lower of its tax or the foreign tax. Thus, if the foreign tax on income subjected to U.S. tax is less than or equal to the present U.S. top marginal corporate rate of forty-six percent,⁴³ that income will bear a total tax of forty-six percent. If the foreign tax is higher than the U.S. rate, the United States will get no tax and the income will have been subjected to that higher foreign rate. This "excess" of foreign tax over the U.S. rate may, under certain conditions, be used to offset U.S. tax due on other foreign source income in the same year or other years.

Although U.S. taxpayers can treat any foreign tax paid directly to a foreign government as a deductible expense, it will normally be more advantageous to claim a dollar-for-dollar credit. Taxes which can be credited are foreign income taxes paid or accrued to a foreign government. For example, foreign income taxes paid by an overseas branch of a U.S. corporation or withholding taxes deducted from dividends, interest, royalties, or other types of income paid from abroad to a U.S. taxpayer can be credited.⁴⁴ Such payments result in a "direct credit." Furthermore, in the case of a U.S. corporate shareholder owning at least ten percent of the voting power of a foreign corporation, the shareholder can claim a credit for an appropriate proportion of the foreign income

⁴¹ See text accompanying notes 24-25 *supra*.

⁴² See I.R.C. §§ 901-908.

⁴³ *Id.* § 11(b).

⁴⁴ *Id.* § 901.

tax liability of the foreign corporation on the earnings out of which it paid dividends to the U.S. shareholders. This is termed a "deemed paid credit."⁴⁵ Where the U.S. corporate shareholder's interest in the foreign taxpayer corporation is held through a series of subsidiaries, this deemed paid credit can extend down through three tiers of foreign corporation, if the proper percentage ownership tests are met.⁴⁶

2. *Limitation.*—If foreign income arises from a foreign country which imposed higher taxes than the United States, the total creditable taxes could conceivably exceed the U.S. tax on that foreign income and offset the U.S. tax on domestic income; therefore, the amount of credit which a taxpayer can use in any year is limited to avoid such an unintended benefit.⁴⁷ Any excess foreign tax credit which cannot be used in a particular year, however, can be carried back for two years and forward for five years and can be treated like foreign creditable taxes for those carryover years.⁴⁸

The foreign income tax creditable in any one year is limited according to the following formula:

$$\frac{\text{foreign taxable income}}{\text{total taxable income}} \times \text{U.S. tax on total taxable income}^{49}$$

The limitation is computed by aggregating income from all countries from which income is received and likewise aggregating all taxes paid.⁵⁰ This approach is known as the "overall" limitation, which generally results in an averaging of foreign income taxes where income is received from both high tax and low tax foreign countries.

It should be stressed that the numerator of the limiting fraction is foreign taxable income. This usually requires that the taxpayer reduce foreign source gross income, such as dividends, interest and royalties, by allocable expenses in computing the limitation. The IRS in 1977 issued regulations in this area which will adversely affect the credit of many taxpayers by requiring them to allocate a portion of their U.S. incurred expenses against foreign source income.⁵¹

3. *Tax Planning.*—Because of the mandatory application of the overall limitation, tax planning is absolutely necessary where there are a number of foreign subsidiaries in a U.S. controlled group. The U.S. parent company can arrange to receive dividends from its foreign subsidiaries in such a way that very high and very low tax rates average out. Or, in the year when a foreign branch incurs losses thus reducing the numer-

⁴⁵ *Id.* § 902.

⁴⁶ *Id.* § 902(b).

⁴⁷ *Id.* § 904(a).

⁴⁸ *Id.* § 904(c).

⁴⁹ Treas. Reg. § 1.904-1, T.D. 6275, 1957-2 C.B. 428.

⁵⁰ *Id.*

⁵¹ Treas. Reg. § 1.861-8 (1977).

ator of the limiting fraction, it might be advantageous to receive no dividends at all. Dividends are treated as being paid out of the most recent earnings of the foreign corporation, computed under U.S. rules. Thus, foreign earnings, computed by using U.S. concepts, must be considered in arriving at the amount of distribution that will be treated as dividends and the amount of foreign tax attributable to those dividends.

4. *Latest Developments.*—In November 1980 the IRS issued temporary regulations to establish standards for determining when a foreign income tax is eligible for credit—when it is a tax which the United States considers an income tax.⁵² The regulations are extremely restrictive and seem to attempt to severely circumscribe the effectiveness of the credit. Moreover, the overly technical approach to the temporary regulations seems to lose sight of the legislative intent of the foreign tax credit provisions in 1918, the elimination of international double taxation. These criticisms were articulated by the IRS in comments submitted by a vast array of organizations and taxpayers. It is understood that substantial changes will be made before final regulations are adopted by the IRS.

XII. Conclusion

As the above discussion illustrates, a wide range of often very complex tax issues are involved in any international business venture and both U.S. and foreign tax rules must be examined carefully. Care must be taken to avoid hidden pitfalls. Factors such as government incentive programs like the DISC, possibilities for tax deferral, and avoidance of double taxation should all be considered. Thus, before making any foreign investment, the U.S. investor should seek professional advice to ensure that the optimum tax situation is created.

Question and Answer Period

Question: Do you have any special comments for small businesses as opposed to big businesses?

Mr. Hammer: It is not true that the things I talked about today were all aimed at big businesses. The big businessman knows all of these things. He does not have a problem. The rules discussed apply to any taxpayer, and I think that a small businessman should pay greater attention to what I have said than a big businessman, who has his own tax department and an international tax specialist to deal with these problems. For example, suppose you set up a foreign corporation. You have to file a Form 959. Did you know that? The typical small-business financial man does not know that. He has got to know all these things

⁵² 44 Fed. Reg. 36,071 (1979). These proposed regulations were replaced with temporary regulations which the Treasury Department adopted on November 12, 1980. Treas. Reg. §§ 4.901-2, 4.903-1 (1980) (temporary).

and that is why I think that these comments are very relevant to a small business—even more so than to a large business.

Question: Relevant to small businesses, how do you use the tax-deferred funds that are accumulated in DISC activities and keep the DISC qualified, particularly if you do not have a lot of receivables from the parent company?

Mr. Hammer: That is a very difficult problem. I think the answer in part may be that a small business may be better off using a buy-sell, rather than a commissioned DISC, because it has its own receivables. It might then even deal with outside parties and sell products of outsiders. In other words, it reinvests any funds in a real export business—a DISC of substance as opposed to a paper DISC. It might also consider a producer loan. A producer loan is mechanism in the statute to permit a DISC to lend the funds back to its parent company or to another manufacturer who is manufacturing products of export. It is not an easy problem and it is getting more difficult as the years go by. The first four or five years after the enactment of the DISC provisions it was easy but now it is getting more difficult. I think that question is well taken.