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DOING BUSINESS ABROAD–SELECTING THE ENTITY

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The choice of the entity for doing business abroad is probably the single most important decision that the U.S. company is faced with when it first contemplates a venture outside the United States. Some companies probably take the easy way out and never consciously face the question when the opportunity for overseas business arises. Consider, for example, the U.S. manufacturer who receives a large order for the sale of his product to a customer in a foreign country. His immediate reaction, particularly if business in the United States is slow, and perhaps the correct reaction is to fill the order. Such a business client would not be too pleased with the serious tax advisor who encourages him to hold up, at the risk of losing the order, until a proper study can be undertaken to determine the appropriate entity with which to do this piece of business. And yet, perhaps a delay would be in order. If the profit on the order is marginal, it could be wiped out by unknown controls or restrictions on doing business in the foreign country in question.

Suppose that, unbeknown to the U.S. manufacturer, the foreign country requires an import permit before allowing the conversion of currencies with which the purchaser can make payment to our manufacturer vendor. Suppose further that a permit will not be granted for our manufacturer's product if the vendor is a U.S. company. What profit is there to have sold the goods if the manufacturer is prevented not only from obtaining his gross profit but also from recovering his investment in the goods sold? Alternatively, consider a positive effect that a delay permitting the choice of the proper entity might have. Take the situation in which an otherwise noncompetitive price quotation could be made competitive if the transaction were structured so that proper advantage was taken of all available tax and other incentives.

These are simple illustrations of the way in which the choice of the entity to do overseas business can have an effect in the most basic of overseas transactions, the export sale. We cannot properly cover here all of the factors that would influence the choice of entity even in this simple set of circumstances. Obviously, therefore, neither can we do so with respect to much more complex overseas business arrangements. Instead, what we will attempt is to focus all of our attention on what often looms as the major determinant in the choice of the entity, the combined U.S. and foreign income tax effect.

BASIC ALTERNATIVES

There are admittedly innumerable specific forms of organization under which a U.S. company can choose to do business abroad. A branch of a U.S. corporation; a U.S. corporation qualifying as a Possessions Corporation, a Western Hemisphere Trade Corporation or a DISC; a foreign corporation; a U.S. or a foreign partnership—these are but a few of the possibilities. Essentially, however, the choices will narrow down to two: to conduct the business within and as a part of a U.S. entity or to conduct the business through a foreign entity. In either case, the entity could be one specifically organized for the purpose of conducting the business in question or could be an existing entity which would conduct the business as a branch or division.

Within the context of these two basic alternatives we will first discuss in a very general way the major advantages and disadvantages of the U.S. and foreign corporations and will then turn to a discussion of specific applications and variations of each.

MAJOR INCIDENTS OF A U.S. ENTITY

Even if this is the first overseas venture of the U.S. business, the U.S. tax effect of operating through a U.S. corporation is generally known. Therefore, a base will already have been established for distinguishing the foreign from a U.S. corporation. This will assist greatly in comparing the advantages and disadvantages of each in a particular set of circumstances.

It is well established, of course, that a U.S. corporation will be taxed by the United States on its worldwide income, without regard to source. Except, then, for the allowance of a credit for any taxes paid to the foreign jurisdiction, the U.S. tax effect of conducting the proposed overseas venture through a U.S. corporation can be viewed as not too dissimilar from the tax effect of undertaking a domestic venture. If the venture operates at a loss, immediate U.S. tax benefits can be obtained by offsetting the foreign loss against domestic profits, either as a result of operating in branch form or through the filing of a consolidated return. The profits of the overseas venture can be immediately utilized by the parent without the intervention of any U.S. tax on dividends, again either as a result of operating in branch form, through the filing of a consolidated return, or as a result of the dividends-received deduction. Most other tax benefits and incentives normally available to U.S. corporations will be available to the overseas operation simply by virtue of its being conducted under the umbrella of a U.S. corporation. The U.S. corporation, therefore, has as its major advantage, from a U.S. tax standpoint, simplicity and familiarity. Even though the venture in question is wholly foreign, it will be taxed in the United States in the same way as if it were a wholly domestic operation.

From this simplicity, however, flows the major disadvantage of a U.S. corporation. Many foreign countries with which the U.S. corporation might be doing business have lower tax rates than our own. Many offer special incentives to foreign investors to do business in their countries, these incentives having the effect of further lowering and in many cases eliminating the foreign tax burden. The use of a U.S. corporation can have a twofold negative effect in these regards. First, the incentives may not be available to a U.S. corporation. In fact, many countries impose a branch tax over and above the normal corporate burden if operations are conducted in a corporation foreign to that country. Second, and more important, however, is the U.S. tax itself. The U.S. corporation loses all of the benefit of lower foreign tax rates as long as its income is fully taxed by the United States as it is earned.

MAJOR INCIDENTS OF A FOREIGN ENTITY

The foreign corporation has its major advantage in the disadvantage of the U.S. corporation. Unless the provisions of Subpart F apply and cause certain undistributed earnings to be taxed currently to the U.S. shareholder, the foreign corporation that is not operating within the United States will not be subject to U.S. income tax. Neither will its shareholders be subject to U.S. tax until the foreign earnings are distributed or otherwise made available to the shareholders in the form of dividends. Assuming, then, that the foreign rate of tax on the foreign corporation is less than the U.S. rate of 48 percent, the use of a foreign corporation permits the deferral of U.S. tax to the extent of the rate differential.

With the deferral benefit there also flow disadvantages. With limited exceptions for companies formed in Canada and Mexico, a foreign corporation cannot be included in a U.S. consolidated return. As a result, if the venture operates at a loss, no U.S. tax benefit can be obtained for the losses. Similarly, because the foreign corporation cannot be included in a consolidated return, dividends from it are fully taxable to its shareholders and have the resultant effect of ending the U.S. tax deferral. The deferral itself, while a tax benefit, can be a disadvantage. The U.S. shareholder has no access to the funds of a foreign corporation short of a dividend and, as will be noted in the ensuing discussion, the controlled foreign corporation is even precluded by section 956 of the Internal Revenue Code from investing in most U.S. property without causing an imputed dividend to its U.S. shareholder. The deferral will, therefore, give rise to a benefit only if the funds upon which U.S. tax has been deferred can be productively put to use in the foreign country.

A final general disadvantage of the use of a foreign corporation is in the requirement of section 367 of the Internal Revenue Code that advance approval of the U.S. Internal Revenue Service be obtained before the foreign corporation can be organized, reorganized and/or eventually liquidated under the tax-free provisions of the Code. The ruling guidelines issued under this provision are such that, in general, advance approval will not be granted for the formation of a foreign corporation in a tax-free transaction except to the extent that the assets being transferred will be used in the active conduct of a trade or business within the foreign country of incorporation. These guidelines effectively prevent the use of a foreign corporation to engage in such passive income-producing activities as investment holding, trademark and patent holding, and passive rental operations. They also generally require that at the time of eventual liquidation any undistributed earnings be taxed to the U.S. shareholder as a dividend. This requirement virtually insures that the benefit of lower foreign tax rates is limited to deferral.

U.S. TAX INCENTIVES

Let us turn now to some specific applications of these general rules and focus on some special circumstances where a U.S. corporation, with all of its disadvantages, could nonetheless be more desirable than a foreign one.

Strange as it may seem to some, the U.S. tax law currently offers a number of tax incentives for doing business abroad. Most are no doubt familiar with the Domestic International Sales Corporation (DISC), because of the publicity attendant on its birth. Many U.S. businesses have formed DISCs or have at least considered the desirability of one in their international operations. But the DISC is only one of the forms of incentive available. There may be a tendency to overlook the others when considering the choice of the entity with which to conduct overseas operations. Let us briefly review the others and compare them with the DISC and with the foreign corporation.

- **Western Hemisphere Trade Corporation.** The Western Hemisphere Trade Corporation (WHTC), the taxation of which is covered by sections 921 and

922 of the Internal Revenue Code, has been with us since 1942. The enabling provision was enacted in an effort to make U.S. business more competitive with European companies which were at that time operating in the Western Hemisphere with the advantage of home-country tax concessions. Our concession, or the benefit granted by section 922, is in the form of a special deduction equal to 14/48 of the otherwise taxable income of the eligible corporation. The result is an effective rate of U.S. tax equal to 34 percent.

A WHTC is first of all a domestic or U.S. corporation that conducts all of its business, other than so-called incidental purchases, in the Western Hemisphere. It must derive 95 percent of its gross income for a three-year period from sources outside the U.S. and must derive 90 percent of its gross income for the same period from the active conduct of a trade or business.

Generally, we think of the WHTC as a vehicle for trading activities in the Western Hemisphere. Goods are manufactured in the United States by one entity, sold to the WHTC and resold by it to Western Hemisphere customers, with title passing outside the United States so as to produce the required gross income from sources outside the United States. This is a typical pattern and undoubtedly represents the activities of a majority of the existing WHTCs. But the WHTC need not be so limited.

Generally, a WHTC cannot be used to conduct both U.S. manufacturing and Western Hemisphere selling activities. This is because it is subject to the usual rules of sections 861-63 of the Code for purposes of determining the source of its income. And without getting into the details of those rules, it would probably be fair to say that, except in most unusual circumstances, a U.S. corporation cannot derive 90 percent of its gross income from non-U.S. sources if it is manufacturing here. You will recall that income from the purchase of goods within the United States and sale outside is wholly income from sources outside the United States. On the other hand, income from the manufacture of goods within the United States and sale outside is partially U.S.-source and partially foreign-source income.

But, because a WHTC cannot be used if the manufacturer is located in the United States, this does not prevent it from being used as a vehicle for conducting manufacturing activities outside the United States. Assuming that foreign tax benefits are neutral to either a U.S. or a foreign corporation, it would seem that generally there would be a definite advantage to using a WHTC to conduct Western Hemisphere manufacturing and sales activities whenever the foreign tax rate is at least 34 percent but less than 48 percent. By so doing, the usual deferral benefit of lower foreign taxes becomes absolute because the WHTC, unlike the foreign corporation, can be included in a U.S. consolidated return. Where the foreign rate is less than the U.S. effective rate of 34 percent, the benefit of the deferral that would result, to the extent of the rate differential, by the use of a foreign corporation must be compared with the previously mentioned U.S. tax disadvantages of a foreign corporation.

Another possible use of the WHTC that is often overlooked is in the 10 percent of its gross income that can be derived from sources other than the active conduct of a trade or business. A high-gross/low-net Western Hemisphere trading operation can be used effectively to reduce the U.S. rate of tax from 48 to 34 percent on passive income from non-U.S. sources. Take, for example, the U.S. manufacturer with a WHTC who is directly licensing patents and other technology outside the United States. Say, for sake of discussion, that the WHTC has gross income (sales less cost of sales) of $1 million and net income of $100,000. That gross income of $1 million would permit the U.S. manufacturer to transfer to his WHTC assets that produce gross, and probably net, passive income in excess of $100,000 without violating the 90 percent active-business requirement. And, incidentally, the patents and other technology could be transferred tax free without the necessity of the section 367 ruling that would be required for a transfer to a foreign corporation.

There are some disadvantages to the use of a WHTC: the fact that in consolidation there is a special foreign tax credit limitation, the fact that WHTC dividends do not give rise to the indirect or deemed-paid foreign tax credit—to name two. The point is simply that the vehicle is relatively flexible and should be taken into consideration when choosing the entity with which to go abroad.

- **Possessions Corporation.** The Possessions Corporation, defined in section 931 of the Code, is more limited in its usefulness than the WHTC but also is more generous in its benefits. This also is a domestic U.S. corporation, but it is not subject to U.S. tax on income from sources outside the United States as long as the income is not received by it in the United States. To qualify for this special treatment, the U.S. corporation must derive for a three-year period 80 percent or more of its gross income from sources within a possession of the United States and 50 percent or more of its gross income from the active conduct of a trade or business.

Without going into detail and being repetitive, it should be apparent that the Possessions Corporation offers the same advantage of shielding passive income as does the WHTC. The percentage of its gross income that must be active is, in fact, only 50 percent, and as much as 20 percent of its gross income can be from non-U.S. sources outside a Possession. The Possessions Corporation is the ideal vehicle where the foreign rate of tax is very low or where the tax has been forgiven under a grant of tax exemption such as Puerto Rico offers to qualified enterprises.

The Possessions Corporation has a lot of the inherent disadvantages of a foreign corporation in that it cannot be included in a U.S. consolidated return and its dividends are not eligible for the various dividends-received deductions. On the other hand, its dividends are treated as if received from a foreign corporation and, therefore, carry with them the deemed-paid foreign tax credits available to a 10%-or-more corporate shareholder. Further, since it is a domestic corporation, a wholly owned subsidiary can be liquidated tax free without the necessity of a section 367 ruling. Unlike the foreign corporation, therefore, its reduction of taxes becomes a saving, not a deferral.

Before leaving the Possessions Corporation, perhaps a word of caution is in order about the use of this vehicle where initial losses are envisioned. The Internal Revenue Service takes the position that if a loss corporation meets the definition of section 931, then, notwithstanding the fact that it might also qualify as a WHTC, it cannot be included in a consolidated return. There is a Tax Court case to the contrary, and there have been various legislative recommendations to clarify the area. It would seem prudent, however, to exercise caution until the matter has been resolved. If initial losses are contemplated in a Possessions operation or may be voluntarily generated, for example through accelerated depreciation, the operation should probably be conducted during the loss period as a branch of the U.S. parent and incorporated into a Possessions Corporation only when profitable operations have been achieved.

- **Domestic International Sales Corporation.** As mentioned previously, the DISC has been somewhat overdone, so that it would not seem productive to give it full treatment here, even in the context of an alternative form for the conduct of overseas business. Some mention, by way of comparison, must, nevertheless, be made.

A DISC is, of course, like a WHTC and a Possessions Corporation, a domestic corporation. It must derive 95 percent or more of its gross receipts from a specially defined category of receipts, essentially export receipts, and must maintain 95 percent of its assets in qualified investments, essentially export-related properties. The incentive for qualifying as a DISC is the deferral of U.S. income tax on 50 percent of its profits, an amount that can be artificially determined by the application of special intercompany pricing or income allocation rules.

In the context of a 48 percent U.S. tax rate, therefore, a DISC can be viewed as a U.S. entity with an effective current U.S. tax rate of 24 percent with the balance of the 48 percent being deferred until the parent requires the use of the DISC's earnings in a manner that the 95 percent assets test will not permit.

There are some interesting considerations in evaluating the DISC as a choice of entity. As with the WHTC, we might generalize and conclude that where the foreign rate of tax is between 24 and 48 percent the DISC should be considered as the vehicle. On the other hand, the DISC benefit is in deferral, much like that of the foreign corporation, so that it cannot be compared on a tax-rate basis with the WHTC, the benefit of which is in tax reduction. Yet, the DISC has definite advantages over both the foreign corporation and the WHTC. As to the WHTC, the 24 percent deferral rate is likely to apply to a much higher base. The special pricing rules may permit the U.S. manufacturer to allocate to his trading DISC a much higher proportion of his total manufacturing and sales profit than the regular rules of section 482 would allow to be allocated to a trading WHTC. In comparison with the foreign corporation, the DISC has much greater flexibility in making its tax-deferred earnings available to its manufacturer parent. The ability to finance the parent's export inventories and receivables or to loan its funds to its parent through a producer's loan makes the DISC's earnings, even though tax deferred rather than tax reduced, much more accessible to the parent than the funds of a foreign corporation which cannot even be invested in most U.S. assets.

- **Other U.S. Incentives.** We have just touched on the major U.S. incentives to the conduct of foreign business in U.S. corporate form. There are a number of others that are not limited to overseas operations, but have the effect of reducing the effective rate of U.S. tax below the statutory 48 percent and may make it advantageous, from a U.S. tax standpoint, to opt for a U.S. rather than a foreign corporation. Two that come immediately to mind are the deduction for percentage depletion and the deduction for intangible drilling and development costs. These are limited to overseas ventures in the natural resource exploration field, but mentioning them may stimulate thought as to others. These two deductions apply equally to income from foreign and from domestic operations, but they are available only if the foreign operations are conducted in U.S. corporate form. Another limited benefit that comes to mind and equally illustrates the point is the capital-gain treatment afforded by the Code to income from the cutting of timber. The effect of all of these and similar U.S. tax incentives can be to reduce the U.S. rate of tax on the foreign operations conducted in U.S. corporate form to an effective rate that is low enough to neutralize the tax deferral benefit that would otherwise result from the use of a foreign corporation.

FOREIGN TAX INCENTIVES

In highlighting the benefits available under U.S. tax law through the use of a U.S. corporation for overseas business, it might seem that we are painting a picture of the undesirability of a foreign corporation. This is not at all intended. In terms of sheer volume and effect, foreign tax incentives probably far outweigh U.S. incentives. These incentives, offered to foreign investors to do business in various foreign countries, have in fact proved so successful in attracting U.S. overseas investment as to warrant recommendation by the administration, with its "tax holiday" proposals, that the U.S. law be amended to negate the foreign incentive benefit.

In talking of foreign tax incentives in the context of the use by a U.S. investor of a foreign corporation to conduct overseas business, it should be noted that in many cases the incentives are not limited to corporations formed within the country granting the incentive. On the contrary, the objective of most incentive programs is to attract foreign business operations, not to attract incorporations. However, in the prior general comments comparing U.S. and foreign entities it was noted that as long as the United States continues to tax the foreign income of a U.S. corporation as it is earned and as long as the U.S. effective rate exceeds the foreign rate, the benefit of the incentive is lost if a foreign corporation is not used.

It would not be productive to attempt to comment on a number of specific foreign incentive programs. Suffice it to say that they generally are of two or three basic forms.

- **Tax Exemption Grants.** There is first of all the typical grant of tax exemption, in whole or in part, for a specified period of time. Examples of this are the highly successful Puerto Rico Industrial Incentives Act, popularly known as "Operation Bootstrap;" the program of the Irish Development Authority; and similar programs offered by such countries as Brazil, Italy and Malta. The overseas business operations that can avail themselves of these kinds of programs are generally active business operations, the incentive being offered to attract the investment and the business rather than the incorporation. These are also the operations that would generally not run afoul of Subpart F if conducted through a foreign corporation.

- **Tax Havens.** The second kind of foreign incentive is the tax-haven country, i.e., the country with low or no income taxes. Examples of those with no income tax are Bermuda, Bahamas, Cayman Islands and New Hebrides. Jurisdictions such as Netherlands Antilles, Switzerland, Panama and Luxembourg offer low overall tax rates or special low rates for certain types of activities. The problem with these countries is generally that there is little business opportunity within them (Switzerland perhaps being a notable exception), so that what they offer is usually a place of incorporation with the understanding that actual business operations will be conducted outside their borders. The Revenue Act of 1962 went far in eliminating the opportunity to utilize these countries. They were traditionally used to house patent and investment holding companies and offshore trading companies which did little more than act as conduits for the the collection of income from sources outside their countries of incorporation. Since, as will be seen in the ensuing discussion, the income of such companies will in many cases be taxed to the U.S. shareholder, whether distributed or not, there is little benefit to be derived from the avoidance of foreign taxation. The tax havens, nonetheless, continue to have a role in the structuring of international operations, either because of exceptions to the provisions of Subpart F or because the overseas operation in which the U.S. investor will have an interest will not be a controlled foreign corporation.

- **Other Incentives.** The third general category of foreign tax incentives of which the new overseas business should be aware encompasses local (foreign) deductions allowed in arriving at taxable income. These take as many forms as there are countries. Examples include the 100 percent writeoffs allowed by the United Kingdom for investment in new plant and machinery; the two-year writeoff allowed by Canada for similar investment; and the flexible depreciation allowance permitted by Puerto Rico, under which depreciation can be timed to eliminate up to 50 percent of taxable income. As with the first group of incentives which give outright tax exemption, these incentives are not necessarily limited to companies incorporated in the taxing foreign country, but in some cases they are. In other cases, the incentives may be available to a corporation foreign to that country, but they may be partially or fully negated by a branch tax on unremitted earnings or a different rate of tax applicable to corporations foreign to the host country.

TAX TREATIES

The final specific area deserving of comment as a major factor influencing the choice of entity with which to do business abroad is the matter of income tax treaties. Some say that in the area of international taxation the best advice that can be given to a prospective investor is to ignore the income tax laws of the countries under consideration and instead simply to look to the countries' networks of income tax treaties. This is, of course, an oversimplification when the investor is a U.S. person since, under U.S. law, treaties are generally implemented by full taxation of the U.S. person in the ordinary course and then the avoidance of double taxation as intended by the treaty through foreign tax credits. Notwithstanding this, the treaties, of which the United States is a signatory to almost thirty (with an additional twenty or more countries covered in one form or another), must be given full consideration in the decision as to choice of entity.

All of the U.S. treaties define in one way or another the extent to which commercial activities of an enterprise of one country can be conducted within the other without exposing the "foreign" corporation to tax. These provisions usually provide a definition of permanent establishment and generally delineate the extent to which income derived in a country will be considered effectively connected with a permanent establishment therein. They will usually be of most interest to our prospective investor once a decision has been made to use a U.S. corporation and the objective is thereafter to keep the foreign tax rate below that of the United States.

The other provisions of the treaties that will warrant consideration are those providing for exemption from foreign tax withholding or for reduced-rate withholding on income payments from the country in question. Typically, these provisions cover dividends, interest, royalties and other payments of technical fees. It is not practical to discuss the application of these treaty provisions in the abstract, but perhaps a couple of examples will leave the awareness we are trying to stimulate.

Assume, for example, that our prospective investor, because of exceptions to Subpart F or otherwise, is able to utilize a tax-haven corporation in Bermuda to hold patents and to collect foreign royalties thereon. By using Bermuda as his base he will have avoided both U.S. and other direct foreign taxes on the royalty income as it is earned. But, because Bermuda has no income tax treaties, he may have simply substituted a withholding tax at source for a direct income tax. Royalties from Holland, for example, would carry a 25 percent withholding tax when paid to a Bermuda corporation. In contrast, had he chosen a Netherlands Antilles corporation he would probably have been subjected to an Antilles tax of 2.5-3 percent as the royalties were earned, but, because the Antilles has a treaty with Holland, the royalties could have been paid to that country free from any withholding. Simply by taking advantage of treaties, therefore, our investor would have substantially increased his U.S. tax-deferred royalty income.

Staying with the same example, suppose our prospective overseas venturer is the one whose WHTC had a sufficient amount of gross income to permit him to transfer passive income to it without destroying its status as a WHTC. Now his choice is between directing his royalties to Bermuda, where Holland will withhold 25 percent, or directing them to his WHTC, a U.S. corporation for which the treaty between Holland and the United States provides exemption from withholding. Some quick arithmetic might lead one to conclude that there is no choice, since the 25 percent rate paid through Bermuda is still lower than the WHTC's 34 percent. But, as we have previously discussed, the \$.75 aftertax earnings in Bermuda will be relatively inaccessible, whereas the \$.66 aftertax earnings of the WHTC are immediately available to the U.S. investor. Further, the \$.75 Bermuda earnings will eventually be taxed by the United States when remitted in the form of a dividend, whereas the \$.66 earnings of the WHTC have completed the corporate tax cycle.

U.S. FOREIGN TAX CREDIT

Perhaps we could stay with this example to illustrate the final, but nonetheless very important, factor influencing the choice of entity: the U.S. foreign tax credit position of the U.S. investor.

As you know, section 904 of the Code provides limitations on the amount of foreign taxes paid or accrued by U.S. persons that can be claimed as credits against U.S. tax. Essentially, the limitation is that percentage of the U.S. tax represented by the ratio of foreign-source taxable income to total taxable income. Generally, little can be done to control the denominator of this fraction that is not already being done under the name of good general tax planning. But much can be done to influence the numerator, and here the choice of entity can be a controlling factor.

In our example of the overseas investor faced with the dilemma of choosing between the Bermuda corporation and his WHTC, would there really be any choice if his WHTC was currently generating excess foreign tax credits, and the inclusion in its income of the untaxed Dutch royalties would have the effect of eliminating that excess? If the excess credits could not have otherwise been utilized, the result of choosing the WHTC would have been to permit the receipt of the Dutch royalties free of both Dutch and U.S. tax. •