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Andre A. Avers

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THE ADVENTURES OF INTERNATIONAL TAXATION

By ANDRE A. AVERSA
Director of International Tax
Touche Ross International

"Is it lawful to pay taxes to Caesar or not?" When Christ was asked this question 2000 years ago, His reply was simple: we should render to both God and Caesar.

I do not want to distort the conflict between the world and the spirit in this story, but it may be noted that it made no reference to double taxation, a concept of taxation that dominated the centuries until 1907, when in Genoa, Italy, a group of scholars held the first international conference to meet the new challenge of worldwide trade. The last 68 years show progress toward what I believe is the ultimate goal: rendering one account to the Caesars of our world on a basis acceptable to all of them.

Finally, after World War II, the United States joined in this effort. At present, while it is negotiating a series of treaties, the United States has, in common with most of the industrialized nations of the world, tax laws that have reached high levels of complexity. In the developing nations, on the other hand, such laws are often so brief and cryptic that planning a business transaction can be rather adventurous. For example, in one Arab country there are no written tax regulations whatsoever. Between these two extremes, of course, the complexity of tax rules varies from nation to nation.

A common thread among tax rules is that they are designed with two objectives: (1) to raise revenue to finance public activities, and/or (2) to encourage or discourage certain private activities. For instance, in the States, allowance of the investment credit is designed to stimulate capital outlays as a means of creating increased employment. Whereas in Brazil, incentives are available when a business invests in property, plant, and equipment in order to encourage manufacturing goods for export. The measure is designed to attract capital to Brazil, create jobs, and improve the country's balance of payments.

Obviously, each country's tax laws do not fit into a neat symmetrical pattern; they are, rather, the product of whatever priorities and problems are faced by the nation and its people. Let's discuss a couple of examples in which a business transaction takes place in two countries, and see how the tax laws of the two nations must be correlated so that the taxpayer does not face an excessive tax burden.

The Case of Corporation "X"

First, we have a hypothetical US corporation, which for the first time is planning to expand its operations into foreign markets. Initially there will be salesmen, but eventually it will have manufacturing facilities located abroad.

To arrive at the optimum international tax plan consistent with operating realities, a number of factors must be considered. While there is no prescribed order, these factors do require an analysis of the tax laws of the United States and the other country concerned, as well as any agreements or treaties between the two.

For example, it must be determined whether or not the activity planned in the foreign country will subject the US corporation to tax in that country. If there is a tax treaty (and it must be realized that there are many countries with which the US has no such treaty), an answer may be obtainable. Typically, industrial or commercial profits generated by a resident of one treaty country are exempt in the other treaty country, if the taxpayer does not maintain a *permanent establishment* in the other country. Since the definition of "permanent establishment" varies from treaty to treaty, it is difficult to generalize about this term. It is used often but rarely defined.

In addition, the appropriate form of organization must be selected. This will involve studying the laws of both countries. Questions to be considered here include the current deductibility of losses, insulation of the US corporation from liability, effective tax rates and foreign tax credits, differing methods of accounting, and commercial and trade regulations. The US corporation could decide to use an unincorporated branch of the US corporation, a separate US corporation, a wholly-owned foreign subsidiary, or a partnership. Other possibilities which must be considered include the use of a foreign holding company, a Domestic International Sales Corporation (DISC), a Western Hemisphere Trade Corporation (WHTC), a financing subsidiary, or an offshore captive insurance company. This

is necessary to assure that every substantial tax benefit is received; but of course whatever decision is made, it also must make business sense.

The form chosen may call for personnel to live abroad, which will certainly require a multiplicity of reports and forms. It will also force management to justify for tax purposes the value of certain functions which are performed abroad. (Obviously, the local management is interested in showing the highest profit, as is the local government, while the US government is interested in allocating income and expenses in order to generate the highest US tax.)

The Case of Subpart F

Sometimes the tax rate in a foreign jurisdiction is lower than the prevailing rate on the same income in the US. In this situation, a US tax deferral may be the major goal of the international tax plan.

Prior to 1962, US corporations paying low foreign taxes could generally obtain a US tax deferral by creating a foreign subsidiary. The product could be manufactured in a low tax jurisdiction—Hong Kong, for example. Then, by incorporating the firm either in Hong Kong or in a third country, such as Switzerland or Bermuda, little or no tax would be generated.

This was possible because US corporations operating abroad could create structures that would avoid a US tax until an actual distribution of the profits was made by the foreign subsidiary to its US parent. As a result, expansion of foreign operations could be accomplished much faster than could that of US operations, which were subjected to the full US and state tax burdens.

With the passage of the Revenue Act of 1962, however, all this changed. The ability to defer the US tax was limited and became much more complicated through the enactment of a series of rules known as Subpart F, which can require current US taxation of foreign earnings regardless of the timing of repatriation to the United States.

Under Subpart F, if our hypothetical US corporation created a Swiss sales subsidiary with a Hong Kong manufacturing plant and then sold its product to its other foreign subsidiaries at a reasonable markup, the US tax deferral on the earnings of the Swiss corporation would be lost. (There are exceptions but their applicability cannot be studied in this brief review.)

If no exception clauses did apply, the Subpart F income of the foreign corporation would be taxed currently to the shareholders as a deemed dividend from the Swiss sales subsidiary—even though no actual distribution of profit had been made.

Without proper planning, therefore, the current tax burden on the US corporation's foreign income would jump from a very low foreign tax rate to the current US rate of 48 percent.

Planning depends upon each individual situation. For instance, one can avoid Subpart F status if the sales income is generated by a firm incorporated in the same country in which the product is manufactured. That is, if the sales subsidiary is located in Hong Kong and the goods sold are manufactured in Hong Kong, one can avoid the current US tax on the earnings of the Hong Kong subsidiary.

Should an easy solution not be available, of course, then the tax planner must investigate less obvious exits from the Subpart F problem.

The planners must also recognize another weapon in the government arsenal: section 482. This is a provision which permits the government to reallocate income and expenses among related taxpayers. Recent years have seen the steady development of a more rigorous government attitude in the application of these rules. It is also interesting to note that many other countries have rules similar to section 482, and this can lead to conflict between two countries concerning which country shall have the right to tax the income. Tax credits may provide only limited relief. If there is a tax treaty, of course, possible relief may be obtained through negotiations between the tax authorities of the two countries.

The Case of the Three-Country Commuter

Let us now switch to tax planning for individuals. What happens when a US citizen who resides in France drives to his employer's office in Switzerland, then returns each evening to France? What are the tax consequences? All three nations, the United States, Switzerland, and France, have a stake in this situation, and under the general tax rules of each, some income tax may be payable to each. Should our commuter therefore give up his French residence and move to Switzerland?

First, a careful reading of the United States Income Tax Conventions with Switzerland and France, as well as that between Switzerland and France, is essential. This must be followed by an analysis of the tax statutes of each of the three jurisdictions.

Because the pertinent rules do contain some ambiguity, one should consider the amounts of tax involved. It may be worthwhile, indeed, to take an aggressive position, since given the US earned-income exclusion for certain income earned abroad, only Swiss federal, cantonal, and municipal taxes might be payable.

Planning, however, cannot limit itself to examining the tax ramifications. It must also be integrated with the operating realities of the enterprise and the business and political climate of the country.

What if exchange control restrictions and other balance of payment considerations lock the earnings into a given area? Care must be taken to determine if earnings can be reinvested properly. Governmental restrictions or incentives can be the key to any international tax plan.

US and foreign taxes should also be secondary considerations, if the pricing schedules are the major factor by which management is being judged. This situation can develop if an internal manager wishes to reflect large profits in his particular country in order to show good operating results, even though good tax planning dictates a different pricing structure.

Top management must be alerted whenever the tax costs of an intercompany pricing structure become unreasonable as a result of internal profit-center accounting. A good tax adviser will suggest an alternative to forestall any company personnel being in a position to contravene the firm's optimum pricing structure.

Of course, favorable tax consequences should be sought, but only on a sound business basis. There is not much sense in setting up a plant in Ireland to take advantage of the tax holiday, if the goods produced can be more efficiently manufactured in the United States for about the same delivered cost.

Tax havens must be planned with an eye to economic realities, so that the tax tail in no event will wag the corporate dog. It is essential to *quantify* the value of fancy tax plans; often they are not worth the restraints they impose. We must recognize the difficulties inherent in staffing, managing, and coordinating foreign operations. What if a Swiss corporation is created, but work permits for non-Swiss personnel cannot be obtained? The solution may indeed lie in having a Swiss corporation, but in having it headquartered in, say, London (which can create other problems).

Tax compliance should also be stressed. In the last decade many nations have been formally taught by US tax officials how to enforce the international aspects of their tax laws. Failure to recognize this development can have far-reaching effects.

A lack of common sense sometimes causes US companies to artificially structure transactions in a way that will not bear the scrutiny of either US or foreign tax authorities. In one case, the taxpayer went so far with intercompany transactions as to report all *costs* against the US income taxed at the 48 percent rate, while the entire *profit* was reported in an entity incorporated in a tax-haven country.

Some companies seem to take the view that the evasion of taxes in foreign jurisdictions is to be winked at because the jurisdictions do not have the sophistication or manpower to monitor accurately a company's operations. In my view it is no more proper to evade taxes in a foreign country than it is in the United States.

This means that necessary forms, returns, or clearances must always be filed with foreign governments, and taxes paid or accrued. Pricing or other devices which artificially drain income from foreign governments are unwise as long-range policy.

And as short-range policy, too. There is an increasingly sophisticated supervision of tax laws by foreign countries, as well as new criminal statutes—as in Brazil, for example. Moreover, a number of industrial nations are now meeting regularly to examine the pricing policies among subsidiaries of companies which operate in their jurisdiction. These meetings are held at the highest level of government, and information on the activity of multinational corporations is freely exchanged.

Of equal concern is the employee's own compliance abroad. In one typical situation, I traveled six times within a four-month period to avert a disaster for 60 expatriates in Jamaica. If they had been forced to leave, the corporation would have left a large project unfinished.

The days of free-wheeling foreign operations are ending. In time, standard tax-reporting techniques will be adopted by the industrialized countries, particularly the EEC. Hence, one might as well prepare now to adopt compliance procedures that are equal to domestic operation procedures.

Remember, too, knavery is often more costly than compliance. When one client called me to discuss a proposed bribe payment to a lawyer to avoid paying an income tax, I pointed out that the tax was cheaper because it could be credited against US taxes, whereas the bribe, at best, would only reduce the firm's taxable earnings.

Conclusion

Since a foreign country's tax laws may be as complex as those in the US, international tax planning is related to domestic US tax planning as three-dimensional chess is to the two-dimensional game. That is why cooperation among the offices of an international tax adviser can provide a unique service to clients seeking either to expand their operation or to arrive at the optimum tax recommendation.