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1966

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Recommended Citation
Quarterly, Vol. 12, no. 4 (1966, December), p. 10-15

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Tax Considerations in doing Business Abroad

by Michael L. Borsuk

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One of the most striking features of modern business operations is the growing trend toward expanding the scope of activities beyond the borders of the United States. The increasing sophistication of the corporate executive in effecting such expansion has created a need for awareness and knowledgeability on the part of his advisers in many different areas. Perhaps nowhere is this mounting complexity more evident than in the taxation of foreign operations. The development of various techniques employed in operating abroad has been matched, if not surpassed, by the growth of a body of tax rules and regulations designed to impart some measure of equality of tax treatment to the businessman who chooses to operate domestically and to his counterpart operating abroad.

It is the purpose of this article to outline some of the basic tax considerations in organizing, operating and terminating a foreign enterprise. It is important to note that taxability is only one of many important factors to consider in choosing the place and method of operation. Throughout the article, it is assumed that non-tax considerations (such as availability of markets, labor, materials, legal implications, the foreign country's trade policies and incentives) have been taken into account.

Organizational Problems

Let us suppose that ABC, Inc., a manufacturer of a consumer product, wishes to commence selling its product abroad. At the same time, it is considering the possibility of manufacturing abroad as well. The new operation could take one of the following forms:

1. Branch or division of ABC, Inc.
2. Domestic (U.S.) subsidiary of ABC, Inc.
3. Foreign subsidiary of ABC, Inc.

Branch of domestic corporation

The main appeal of this form to ABC, Inc. would probably be its simplicity. There is no need to create new corporations, and thus many administrative problems are avoided. Income earned by the branch could be used by ABC, Inc. for further plant expansion or for any other business purpose without the necessity of a dividend declaration. If the branch operations result in a loss (a possibility in the early years), such loss may be offset against income from the remaining operations of ABC, Inc. Income taxes of the foreign country which may accrue as a result of the branch operation may be credited (subject to certain limitations) against the U.S. tax liability of ABC, Inc. However, the branch income is subject to immediate U.S. taxation as earned. Moreover, the assets of the foreign operation may be reached by creditors of ABC, Inc.

Domestic subsidiary

Many of the aforementioned advantages of a branch may be obtained by the use of a subsidiary corporation, which has the additional feature of insulating the foreign assets from creditors' claims. In order for the parent company to obtain the use of the earnings of the subsidiary, it is necessary to pay the earnings up as a taxable dividend. However, a deduction is generally allowable in the amount of 85% of dividends received from domestic corporations, resulting in an effective tax rate of 7.2% (assuming a 48% overall tax rate). Moreover, in certain instances dividends from a subsidiary to a parent qualify for a 100% dividends-received-deduction, which has the effect of making such dividends tax-free. The same result follows if consolidated tax returns are filed by the two corporations. The consolidated return also serves as the vehicle for offsetting losses of the subsidiary against profits of the parent.

The creation of a domestic subsidiary for purposes of engaging in foreign activities has the same tax result as the incorporation of any other domestic entity. No gain or loss is recognized by the parent on the exchange of the assets involved for stock of the subsidiary. This is simply another example of a tax-free incorporation under Internal Revenue Code Section 351.

Domestic subsidiaries meeting certain requirements qualify for tax benefits beyond those accruing to ordinary domestic corporations. A domestic corporation which does all of its business in the Western Hemisphere, 95% of whose gross income is from sources outside the United States for the preceding three years (or period of existence if shorter), and 90% of whose gross income is from an active (as opposed to investment) business, is entitled to a special deduction in computing its taxable income. This type of corporation is the Western Hemisphere Trade Corporation, a form of operation that has been growing in popularity in recent years because many taxpayers find it difficult to

meet the stringent new rules that apply to the use of foreign subsidiaries. These rules will be discussed later in the article. The effect of the special deduction available to the WHTC is to reduce the top tax rate from 48% to about 34%.

The WHTC has all the other tax features of a domestic subsidiary. The foreign tax credit may be availed of, dividends passed through to the parent will qualify for the special dividends received deduction, and losses may be availed of in a consolidated return.

Foreign subsidiary

It can be readily seen from the preceding discussion that one of the characteristics of a domestically based organization (whether branch or domestic subsidiary) is that its earnings are subject to U.S. tax on a current basis. Deferral of U.S. tax on earnings is the primary characteristic of a foreign corporation. The fact that recent legislation has imposed more stringent requisites for this deferral is no reason for the tax adviser to eliminate the foreign corporation from consideration as one of the available alternatives. If, as discussed below, the foreign operations of a U.S. corporation can be arranged in such a way as to qualify for the deferral, the cash flow of the entity will be enhanced.

In order for the organization of a foreign corporation to be tax-free Section 367 requires that it be timely demonstrated to the satisfaction of the Commissioner of Internal Revenue that the exchange of assets for stock in the new foreign corporation "is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes." This can ordinarily be done by showing an economic connection between the country of incorporation and the planned operations of the business. For example, if ABC, Inc. were to attempt to incorporate a Panamanian subsidiary to manufacture and sell in Europe, it is likely that the Internal Revenue Service would view the choice of Panama as nothing more than a tax haven and would withhold approval. It should be stressed that the consent of the Commissioner must be obtained in advance of the incorporation since he is powerless to approve retroactively. Moreover, the Internal Revenue Service holds that failure to obtain prior approval may not be used as an argument by the taxpayer to obtain a tax benefit (such as where the parent seeks a taxable incorporation in order to use up expiring net operating loss carryovers). No gain or loss would result from the purchase of stock of a newly organized company solely for cash; hence, no advance ruling is required if one is sure there has been no transfer of some other asset such as goodwill.

The potential deferral of U.S. tax is the primary advantage of the foreign corporation. The disadvantages include non-availability of foreign tax credits, absence of dividends received, deductions to the parent and inability to join in consolidated tax returns.

Miscellaneous Organizational Considerations

Two other provisions which must be kept in mind and which may be applicable to all of the forms of organization discussed above are Code Sections 269 and 1551. The former disallows deductions or credits when the principal purpose of a corporate acquisition is to evade or avoid tax by securing the benefit of such deduction or credit. The provision is intentionally worded in broad terms and is often invoked by the Treasury Department when the technical language of more specific statutory rules is met by the taxpayer. Section 1551 is also fairly broad. It denies the surtax exemption to an entity which is not actively engaged in business at the time of acquisition of propertly unless it can be shown that the securing of such exemption was not a major purpose of the transfer.

OPERATIONAL PROBLEMS

Section 482

In order to prevent related entities from dealing with one another in such a manner as to obtain unwarranted tax advantages, the Internal Revenue Code gives the Commissioner broad authority to scrutinize intercompany transactions and to alter them when necessary. Specifically, Code Section 482 allows him to allocate or apportion income, deductions or credits among entities under common control where such action is "necessary in order to prevent evasion of taxes or clearly to reflect the income" of such entities.

This provision gives the Commissioner the ability to attack intercompany dealings which otherwise meet the requirements of the substantive code provisions. It applies to both domestic and foreign entities. Control is deemed to mean actual or practical ability to affect intercompany dealings rather than mathematical control. The parties do not have to deal in a manner tantamount to tax evasion before this provision may be availed of by the Treasury Department. It is enough that the tax liability of the group may be distorted.

Until recently, the Commissioner issued few substan-

tive rules or guidelines for taxpayers to follow in dealing with related parties. Since 1963, however, a series of releases have outlined standards which would be applied in examining intercompany dealings, especially in the area of pricing of goods sold by a manufacturer to a related selling corporation. Basically, the Internal Revenue Service seeks to have the parties deal with each other in the same manner as if they were unrelated. New regulations were proposed in 1966 covering pricing problems, proper treatment of intercompany loans and advances, performance of services for related entities, licensing arrangements, and other areas involving intercompany transactions.

This provision has particular applicability in the case of taxpayers dealing with related foreign entities; any arrangement which has the effect of shifting profits to the foreign entity may result in the inability of the U.S. to tax such income. Indeed, this provision has been used with increasing frequency by the Commissioner in the foreign area, especially in cases in which he may not be able to attack a transaction under a specific substantive code provision. For example, it has recently been applied to allocate profits away from a Western Hemisphere Trade Corporation (taxed at an effective rate of 34%) and to tax these profits at the 48% rate applicable to the U.S. parent.

Subpart F

It has been pointed out above that current U.S. taxes are payable on the income earned by a domestic subsidiary or by the branch operations of a U.S. corporation. However, income earned by a foreign subsidiary would remain sheltered from U.S. taxation until repatriated in one form or another. Prior to the Revenue Act of 1962 a common practice of entities with foreign operations was to incorporate a subsidiary in a foreign country having a low tax rate. Income earned by the subsidiary would be accumulated by reason of the International non-declaration of dividends to the U.S. parent. The earnings of the foreign operation would never become subject to U.S. taxation until such time as the parent deemed it no longer necessary to continue the foreign subsidiary. Then the subsidiary would be liquidated and the gain on liquidation (i.e. the accumulated foreign earnings) would finally be subject to U.S. tax, but at favorable capital gains rates. Because of the low foreign tax rate, this type of procedure was known as a tax-haven operation and the countries chosen for incorporation (often Panama in the Western Hemisphere and Switzerland in Europe) come to be called tax-haven countries. The feature that made tax havens so popular was that the foreign operations did not necessarily have any economic connection with the country of incorporation.

The Treasury Department long recognized the tax-haven operation as one which deprived it of revenues. However, the Kennedy administration was even more deeply concerned about the economic advantage to the domestic corporation operating abroad through foreign subsidiaries. As a result, the 1962 Revenue Act added a new Subpart F to that part of the Internal Revenue Code dealing with foreign income. It contained sweeping new provisions to equalize the tax impact on foreign operations through domestic and foreign entities. Because there were many conflicting policy objectives the statutory language ultimately turned out to be extremely complicated. Congress desired to leave many of the details of implementing the new rules to the Treasury Department. The result was over one hundred pages of complex regulations replete with dozens of examples, exceptions and definitions. Therefore, of necessity, the following description of the new provisions must be brief and sketchy.

Because of constitutional and legal limitations, the tax that is imposed on the foreign operation is levied on the U.S. shareholder (the parent) rather than on the foreign subsidiary. However, the tax is measured by certain types of income earned by the controlled foreign corporation. A controlled foreign corporation is a foreign corporation of which more than 50% of the voting stock is owned directly or indirectly by U.S. shareholders at any time during the taxable year. A U.S. shareholder is defined as a U.S. person or entity owning directly or indirectly 10% or more of the voting stock.

There are three broad categories of foreign activity that will result in current tax to the U.S. shareholders. The most important category involves the type of income that is generated by the foreign subsidiary. Specifically, the "foreign base company income" of the subsidiary is included in the income of the parent. Foreign base company income encompasses several types of income which might be earned by the subsidiary. The most typical in the case of the foreign selling subsidiary of our hypothetical ABC, Inc. is "foreign base company sales income." This income arises when the foreign subsidiary purchases assets from a related party and resells the assets for use outside the country of incorporation of the subsidiary. It should be noted that all of the factors

mentioned must be present. The goods must be purchased from a related party. This need not be the U.S. parent, but could be another subsidiary of the U.S. parent. Secondly, the goods must be sold for use outside the country of incorporation, even if the sale is arranged so that title passes within the country of incorporation. Thus, if ABC, Inc. organizes a Swiss subsidiary and sells its product to that subsidiary, and the product is then resold for use in any country but Switzerland, the income earned by the Swiss subsidiary on the resale will be foreign base company sales income of ABC, Inc. There may also be a current tax to the U.S. shareholder if the foreign subsidiary purchases from unrelated parties and resells to related parties for use outside the country of incorporation. In both situations (i.e. purchase from or sale to related parties), the current tax will not be incurred if the property which is purchased or sold is manufactured or produced within the country of incorporation.

Careful analysis of these rules reveals the intent to tax income derived by a foreign corporation in situations where, as a matter of economic reality, the country of incorporation was not substantially utilized in earning such income. Thus, if the goods are manufactured or sold for use within the country of incorporation, income derived therefrom will not be foreign base company sales income. Furthermore, the statute requires a related party to be involved either at the selling or purchasing end of the transaction, for if both the supplier and purchaser of the foreign subsidiary are independent, there is little danger of its being used by a U.S. corporation to obtain a tax advantage.

Foreign base company income also includes certain types of service, rental and investment income in situations where the earning of such income has little or no economic connection with the country of incorporation and where related parties are involved in the transaction.

If more than 70% of the gross income of the foreign corporation is foreign base company income, then all of the gross income is treated as foreign base company income. Similarly, if less than 30% of gross income is foreign base company income, no part of gross income will be so treated. While these rules were promulgated in order to avoid dealing with minimal amounts, they have resulted in the need for careful planning of the transactions of the foreign corporation whose percentage of foreign base company income borders on either the upper or lower limits described above.

To the extent that these rules result in inclusion of income to the U.S. parent, a credit against a U.S. tax is allowed the parent for a portion of the foreign taxes paid by the subsidiary, much the same as if the subsidiary had declared a dividend to the parent. Furthermore, if income has been included under these rules at the time when earned, it will not again be included when such earnings are actually distributed as a dividend. It can readily be seen why detailed and accurate records must be maintained by taxpayers who come within the provisions of Subpart F.

Because of Administration and Congressional feeling that it is in the interest of the United States to encourage investment in economically underdeveloped countries, there is an exception in the law which excludes from foreign base company income dividends and interest received from investments in "less developed countries" to the extent that such amounts are reinvested in these countries. Any income previously excluded under this exception will be included in the income of the U.S. shareholder in the year such earnings are withdrawn from investment in less developed countries. This is the second major type of inclusion in the income of the parent. Less developed countries are defined as those foreign countries which, on the first day of the taxable year, are included in an "Executive order by the President of the United States designating such country or possession as an economically less developed country." Certain countries are by statute made ineligible for such a designation.

The third broad category of amounts to be currently included in the U.S. shareholders' income is the foreign subsidiary earnings invested in U.S. property. It is felt that if a foreign corporation builds a plant for its parent in the United States or otherwise invests its funds in U.S. property, such conduct is equivalent to the payment of a dividend to the parent and the reinvestment by the parent of such distribution. Therefore, a current tax is imposed on the parent. However, such investment will not be taxed to the extent that it is deemed to consist of previously taxed foreign base company income. This results in a complete set of rules to determine the nature of amounts to be included.

There is an exception to the current inclusion of income under the above-described provisions. Since the purpose of all of these rules is to subject income earned by the foreign corporation to current U.S. tax, and thus to equalize the tax impact on domestic and foreign entities operating abroad, it is felt that if the

foreign subsidiary makes current taxable distributions to the parent, such purpose will be served. Therefore, it is provided that if distributions out of current earnings are made by the foreign corporation in such amounts that the combined foreign and U.S. taxes approximate the 48% U.S. tax that would be imposed on a domestic subsidiary, the inclusions described above will not be required. The percentage of earnings required to be distributed varies with the effective foreign tax rate (the lower the foreign rate, the greater the current distribution required). If a U.S. parent has subsidiaries in several foreign countries, the regulations treat the distribution as being pro rata from each country in order to prevent the parent from making the distribution entirely from high-tax rate countries and obtaining larger foreign tax credits. Many U.S. corporations have resorted to this "minimum distribution" exception during the first years of Subpart F in order to avoid wholesale realignment of their foreign operations. Too often, however, the feeling appears to be that the minimum distribution exception avoids the necessity for examining in detail the other provisions of Subpart F. This is not the case; the determination of the appropriate amounts to be distributed can often be just as complex a procedure as the determination of the applicability of the operative provisions of Subpart F.

Reporting Requirements

To enable the Treasury Department to determine the tax liability resulting from foreign operations, U.S. entities owning or becoming the owner of 5% or more of the stock (directly or indirectly) of a foreign corporation must periodically submit answers to questionnaires which call for extensive information regarding the foreign corporation. Severe penalties are provided for failure to file them.

PROBLEMS ON TERMINATION

Section 367

Under Section 332 of the Internal Revenue Code, no gain or loss is recognized on the liquidation of a subsidiary by a parent provided there is at least 80% ownership of the subsidiary and the liquidation is effected within a certain time period. This rule holds true for the liquidation of a foreign subsidiary. However, just as in the case of the organization of a foreign corporation, Section 367 provides that the Commissioner must give advance approval to its liquidation in order for tax-free treatment to be granted. Ordinarily, such permission will only be granted if the Treasury Department is satisfied that there are no accumulated earnings which have not been subject to U.S. tax. It is common, for example, for the Commissioner to require the payment of a dividend from the foreign subsidiary before permission to liquidate tax-free is given.

Section 1248

If, for one reason or another, tax-free treatment cannot be achieved, the gain on liquidation is required to be recognized. Prior to the Revenue Act of 1962, such recognized gain ordinarily qualified to be taxed at capital gains rates. Most taxpayers felt that this was a small price to pay for the deferral of U.S. tax on the foreign income which in some cases may have accumulated over many years.

Section 1248 was enacted to curb this advantage. It was designed as a companion to the provisions of Subpart F, and is usually applicable in cases where the foreign operations of a particular enterprise have been structured and conducted in such a way as to avoid the application of Subpart F. Section 1248 provides that gain that is recognized on the sale or exchange (including liquidation) of the stock of a foreign corporation will be treated as a dividend (taxable at ordinary rates) to the extent of earnings and profits of the corporation accumulated since 1962. The balance of the gain, if any, still qualifies for taxability at capital gains rates.

Earnings which have been taxed under the provisions of Subpart F are not again included in the measure of earnings and profits for purposes of applying Section 1248. Once again, one finds favored treatment for investments in less developed country corporations; their accumulated earnings will not be subject to the provisions of Section 1248, provided that the stock was owned by the U.S. shareholder for a period of ten years.

Conclusion

It cannot be overemphasized that this discussion is intended as a broad survey, designed to outline as briefly as possible some of the major problems, choices, and decisions confronting the taxpayer embarking on or engaging in business activity outside the United States. As in most areas of taxation, much intelligent thought is required in order to see that all potential advantages are examined and, perhaps of more importance, that all pitfalls are avoided.