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PLANNING FOR OPERATIONS IN SPAIN

JOSE A. DIAZ-ASPER*

In 1959 and 1960 the Spanish Government enacted a series of laws[1] governing foreign investment. The legislation was intended to attract foreign capital by reducing the limitations on participation of foreign interests in Spanish firms and by eliminating the restrictions on repatriation of income and capital.

Since the start of this period favoring foreign investment, American companies have substantially increased their investments in Spain. The form of penetration of the Spanish markets has been as varied as the types of companies that have participated in these operations. Depending upon the financial and administrative involvement it can undertake, a United States corporation usually will choose exporting, licensing, or local manufacturing. These alternatives will be examined in light of governing Spanish and United States legislation. Since many other countries, particularly those in Latin America, have foreign investment legislation similar to that in Spain, this analysis of Spanish problems and solutions hopefully will provide assistance for companies operating elsewhere.

EXPORTING OPERATIONS

Exporting Directly from the United States Through Unrelated Parties

Exporting directly from the United States is the simplest alternative because a corporation is concerned only with seeking Spanish customers for its products. The least cumbersome method of accomplishing this result would be to select a Spanish distributor to handle sales for the company on a commission basis. The distributor would attempt to place the product with Spanish retailers. The American company would not need to concern itself beyond the selection of a good distributor as its agent. This arrangement would be particularly useful if the American company were unfamiliar with the Spanish market or wished to test the product's marketability in Spain. These arrangements are most common in the preliminary stages of operation, when risks are more pronounced and management wishes to proceed with special caution.

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1. Decree Law of July 27, 1959; Decree Law of Sept. 30, 1959; Order of Dec. 24, 1959; Order of Feb. 10, 1960. This policy of liberalization was further developed by adoption of the Code Liberalization of Current Invisible Operations of the Organization for Economic Cooperation and Development (OCED), the Order of March 15, 1962 (replacing the Orders of Dec. 24, 1959 and Feb. 10, 1960), the Decree of May 17, 1959 (which favored the treatment of the foreign investor by making the right to transfer profits and the original investment abroad unlimited in both amount and time). For a comprehensive treatment of these liberalization measures *see* V. GARCES, THE LEGAL POSITION OF THE FOREIGN INVESTOR IN SPAIN 13 (1962).

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The tax implications of this type of venture are also simple. A United States corporation pays tax on all of its income irrespective of where it is generated. If Spanish income taxes are incurred in these operations, United States foreign tax credit provisions[2] would reduce the United States tax liability by the amount of the Spanish tax. It is quite unlikely, however, that any direct Spanish income taxes would be incurred. The corporation could pass title to the buyer in the United States and avoid coming under the source rules of Spanish tax legislation.[3] In this manner the United States company would not be required to pay Spanish taxes.

Nontax reasons also indicate that an American company might not wish to have a permanent establishment in Spain. If a business is classified as a permanent establishment,[4] it is subject to lawsuits, without being able to defend as adequately as if it had its own administrative staff and counsel in Spain. Liability would not be limited to assets in Spain, but would also include the company's assets in the United States. However, exporting directly from the United States probably would not be construed as establishing sufficient "minimum contacts" under conflict of laws principles[5] so as to subject a United States company to Spanish jurisdiction.

Establishing an Export Sales Arm in Spain

After a product has met with considerable commercial success in Spain, an American company might choose to eliminate the middleman. If exporting from the United States is still considered the most prudent course of action, the company might want to establish its own sales outlets in Spain. Because distributors often handle several lines of products, they obviously do not have the same degree of interest or familiarity with the characteristics of the American manufactured product as would a staff of personally trained salesmen running a sales office in Spain. The independent sales operation involves greater risks and costs, but provides a better position from which to aggressively penetrate Spanish markets while retaining close ties with over-all company policy.

This sales arm would be organized either as a branch of the United States parent or as a foreign subsidiary. Spanish legislation presents several disadvantages to the establishment of a branch. Repatriation rights are not guaranteed; a *cifra relativa* concept makes dividends paid by the parent company subject in part to Spanish taxation. The company must also file information

2. INT. REV. CODE of 1954, §§901-05.

3. Under United States source rules the place where the sale takes place determines the source of income and the sale takes place where legal title is passed to the buyer. Therefore, usually it is just a simple matter of arranging under the contract where title is to pass.

4. Under Spanish laws a company does not have a permanent establishment if it does not operate in a fixed place of business or employ resident agents having unrestricted authority to contract for the company. Law 41 of June 11, 1964, art. 71, of the reform of the fiscal system.

5. *See* DIEZ DE VELASCO, PRACTICAS DE DERECHO INTERNACIONAL PRIVALO 323 (1969); Darby, *The Conflict of Laws and International Trade*, 4 SAN DIEGO L. REV. 45 (1967).

relating to all company operations. This latter requirement is burdensome, and carries with it the risk that information considered confidential might fall into the wrong hands. For these reasons most foreign companies usually avoid branches in Spain.[6] If, despite these difficulties, a branch is still organized in Spain, the tax effects will be the normal corporate tax rate of 32.7 per cent.[7] United States taxes would be incurred, but the tax credit relief provisions would prevent double taxation of the foreign income.[8]

American corporations usually prefer to operate in Spain through a locally organized subsidiary. Nationalism is a problem in Spain as in the rest of Europe,[9] and operating through a branch accentuates public relations problems. The use of a Spanish company (Sociedad Anonima) offers the advantages of guaranteed repatriation rights and predictability in the area of tax planning. Although Spanish tax authorities closely question expenses of foreign subsidiaries, a subsidiary company does not have the problem of allocation of dividends or sales profits as does the branch company. In addition, profits generated by a foreign subsidiary will not be taxed in the United States until they are repatriated. Therefore, the company can defer United States taxes; and because the Spanish tax rates are lower than the American rates, there would be a greater source of after-tax profits available for expansion in Spain.[10] However, if losses occur, having a foreign subsidiary will backfire since these losses can not be set off against profits of the parent company.

In the case of export sales operations, some United States companies have found it to their advantage to use a management fee contract in conjunction with the establishment of a Spanish company. This scheme prescribes a fixed percentage, for example, five or ten per cent of sales, for the subsidiary's sales efforts in Spain. The parent company thus avoids having to determine and support the legitimate expense and income factors from its Spanish operation. These agreements have been upheld by Spanish tax authorities and have been demonstrated to be a very favorable solution to the company that wants to maintain only a sales force in Spain and to perform bookkeeping and other administrative functions through a headquarters company. Such an agreement avoids the problem of disallowance of expenses, and facilitates the administrative requirements of the Spanish subsidiary.

Although allocations to several of the activities of branches are made by

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6. *See* V. GARCES, note 1 *supra.*

7. ARTHUR ANDERSON & Co., TAX TRADE GUIDE — SPAIN 109 (1965).

8. INT. REV. CODE of 1954, §§901-05.

9. Karsten, *Should Europe Restrict United States Investments?*, 43 HARV. BUS. REV. 53 (1965); Smith, *European Nationalism Threatens United States Investments,* 72 FORTUNE, Aug. 1965, at 126.

10. The United States foreign direct investment control regulations must be examined to determine if the income will not have to be repatriated. Spain is considered a schedule "C" country and as such the full impact of these regulations is felt in operations in Spain as much as in the developed countries of Europe. For a full treatment on the FDIC regulations *see* CCH BALANCE OF PAYMENT PUBLICATION. Although the regulations have been substantially watered down and might be entirely eliminated, this area must be carefully examined by the potential investor to determine how he is affected.

the Spanish tax authorities and some intercompany charges may be disallowed, sales between related companies are not questioned as frequently as in the United States. In Spain the emphasis is on *indirect,* rather than *direct* taxation. Thus, in tax planning the consideration of import duties and turnover taxes is more significant than consideration of the corporate tax rate.

American allocation problems are met through the application of section 482 of the Internal Revenue Code. This section grants the Commissioner the power to apportion gross income, deductions, credits, and allowances between two or more related parties. He may also make any other allocations necessary to prevent evasion of taxes or to reflect more clearly the income of these related businesses.[11] The Commissioner has been active in utilizing this broad power to reallocate transactions between related parties in foreign operations.[12] The general plan of the proposed regulations under this section is to insure that an arm's-length standard is applied in each of five specific types of intercompany transactions: (1) loans, (2) services, (3) transfers of tangible property, (4) transfers of intangible property, and (5) sales of tangible property.[13]

In terms of exporting operations, section 482 applies only to intercompany sales between the parent and its foreign subsidiary. It does not apply to selling through a distributor (because the parties are not related) or a domestic branch (because there is only one taxpayer).[14] As a result, an American company need concern itself with section 482 only when it is dealing through a foreign subsidiary. This section is designed to prevent taxpayers from shifting income between related entities in an attempt to reduce their United States tax liability.[15] If a company operating through a foreign subsidiary in Spain can allocate income from the United States parent to the Spanish subsidiary its "deferral" possibilities are greater.[16] The company operating in this manner should be aware of the guidelines established by the provisions governing this area[17] and maintain adequate records of transactions.

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11. For a current discussion on the utilization of §482 and the regulations thereunder from the government's point of view, *see* S. Cohen, *How the I.R.S. Intends To Administer the New Regulations Under 482,* 28 J. TAXATION 74 (1968); Surrey, *Treasury's Need To Curb Tax Avoidance in Foreign Business Through Use of 482,* 28 J. TAXATION 75 (1968).

12. *See* Murphy, *The Application of Section 482 to Overseas Operations,* U. SO. CAL. 1967 TAX INST. 731 (1967).

13. Proposed Treas. Reg. §1.482-2 (a), (b), (c), (d), (e), 34 Fed. Reg. 933 (1969).

14. Hewitt, *Section 482 Re-allocation for Income Between Related Persons Up-to-date,* N.Y.U. 22D INST. ON FED. TAX 381 (1964.

15. *See* text accompanying notes 7-10 *supra.*

16. The alternatives discussed so far have not contemplated the possibility of seeking local equity participation to make the operation a joint venture. Section 482 applies only when the United States company has control. Treas. Reg. §1.482-1 (a) (3) (1962) defines "control" as any kind of direct or indirect control whether or not legally enforceable and however exercisable or exercised. A presumption of control arises if income or deductions have been arbitrarily shifted.

17. Generally the standard applicable under the present regulations (§1.482-1) requires: "A controlled taxpayer to be placed on a tax parity with an uncontrolled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer

Exporting Through Base Companies

A United States company that is active in export operations in other European countries and wishes to coordinate these operations with exporting activities in Spain might consider operating through a centralized European office. Such a form of operations would reduce administrative costs because personnel training, advertising, bookkeeping and other functions could be concentrated in one office. Further, it might reduce taxes because the company could incorporate in a "tax haven" country such as Belgium, Liechtenstein, or Switzerland. Strategic location might also enhance the amount of after-tax funds available for expansion.[18]

However, subpart F[19] substantially deters the utilization of controlled foreign base corporations in low tax rate countries. Deferral provisions are substantially eliminated by these sections that tax the United States parent on income when it is earned, whether distributed or not.[20]

A limitation that cushions the impact of subpart F on exporting activities is the provision allowing a partial deduction from "subpart F income" to a controlled foreign corporation.[21] In order to qualify, the controlled foreign corporation must derive at least ninety per cent of its gross income from sources outside the United States, and at least seventy-five per cent of its gross income from export trade income.[22] It then can reduce its foreign base company income by the amount of export trade income. This reduction is

dealing at arm's length with another uncontrolled taxpayer." The existing regulations, however, do not provide adequate guidelines in this area and as a result the courts, taxpayers, and revenue agents have been at odds in determining how to interpret this section. The proposed regulations (see note 13 *supra*) provide tests and standards that do throw some light and predictability in this potentially dangerous area. Many commentators, however, feel the new regulations are unduly complex and still do not correspond with practical business considerations. For an in-depth treatment of section 482, see Mansfield, *The 482 Proposed Regs: The Problems With Which Practitioners Have To Contend,* 28 J. TAXATION 68 (1968); Pergament, *New 482 Regs Provide Arm's-Length Rules, Flexibility in Pricing of Tangible Property,* 25 J. TAXATION 238 (1966); Walter, *Intangible Property and Section 482 Regulations,* 45 TAXES 284 (1967). *See also* notes 11, 12, 14 *supra.*

18. Limitations now imposed on reinvestments of retained earnings seriously limit the possibilities of these base company operations in the developed countries of Europe. *See* text accompanying note 7 *supra.*

19. INT. REV. CODE of 1954, §§951-52. These provisions were enacted in the Revenue Act of 1962.

20. For further discussion of subpart F *see* Brudno, McDonald & Stone, *Seminar: Controlled Foreign Corporations and Export Trade Corporations,* SOUTHWESTERN LEGAL FOUNDATION 5TH INST. ON PRIVATE INVESTMENTS 151 (1963); W. O'Connor, *Subpart F — Controlled Foreign Corporations,* 17 TAX EXECUTIVE 171 (1965).

21. INT. REV. CODE of 1954, §§970-72.

22. INT. REV. CODE of 1954, §971(b) defines export trade income as: (1) property produced, grown or extracted in the United States, which is sold by the C.F.C. to an unrelated person for use, consumption or disposition outside of the United States; and services rendered in respect to sales, installation, or maintenance of such export property; (2) any compensation derived from services performed in connection with the use by an unrelated person outside the United States of patents and other intangibles that are owned by the exporting company; (3) commissions, fees, rentals, and other compensations from the use of export property in rendition of technical services; (4) interest from export trade assets.

Florida Law Review, Vol. 22, Iss. 3 [1970], Art. 2

limited, however, to the lesser amount of (A) one and one-half times the export promotion expenses incurred in the production of export trade income, or (B) ten per cent of gross receipts from export trade.[23] In addition, there is an over-all limitation for such a reduction equal to an amount that bears the same ratio to the increase in the investment in export trade assets of such corporation as the export trade income that constitutes foreign base company income bears to the entire export trade income of such company.[24]

The use of a base company to conduct import sales operations would not change the tax result from a Spanish standpoint unless the company is incorporated in a country with which Spain has a tax treaty.[25] In such a case there is a reduction in the withholding tax on dividends, royalties and interest, depending on the country involved. Another decided advantage of incorporating in a tax treaty country is that more favorable source and "permanent establishment" rules would govern.[26]

SALES AND LICENSING OF INTANGIBLE ASSETS

Sales to Unrelated Parties

An American company that wishes to avoid or abandon export operations because of heavy import duties and possible quota restrictions might choose to sell outright its patented inventions and "know-how"[27] to a Spanish entity or individual or enter into a licensing agreement. Although it is unusual for a company to sell its intangible assets outright,[28] peculiar circumstances favoring this avenue could arise. Possible situations could be: (1) the intangible assets are of such a nature (for example, trade secrets) that unless they are immediately sold they might become publicly known and lose their commercial value; (2) the research department of the United States company might have incidentally discovered a product that cannot be utilized or licensed by the company, and the sale of it is considered the most desirable alternative; (3) a branch or section of the parent company is being liquidated and part of those assets include patents and know-how.

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23. INT. REV. CODE of 1954, §970 (a) (1) (A), (B).

24. INT. REV. CODE of 1954, §970 (a) (2).

25. Switzerland, Germany, France, Finland, Norway, and Sweden.

26. For the actual text of the treaties *see* International Bureau of Fiscal Documentation Service. Generally speaking, Spanish treaties have followed the OECD model and deviate little from country to country.

27. "Know-how" refers to the general category of unpatentable devices and trade secrets that do not enjoy federal statutory protection. Most find protection under the contract agreement or an unfair trade practice remedy in state courts. For a good discussion of "know-how" in foreign trade *see*: L. EKSTROM, LICENSING IN FOREIGN OPERATIONS ch. VI (1963). *See also* Ladas, *Legal Protection of Know-how*, 7 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 397 (1963).

28. *See* Bangs & Creed, *A Review of Taxation Study*, 5 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 35 (1961-1962); Bangs & Creed, *Tax Experience of American Corporations Owning Numerous Patents*, 5 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 199 (1961-1962).

These situations are uncommon, but when they occur the American based company will normally derive capital gains from any profits on these sales[29] because the assets will probably qualify as either section 1221 capital assets (know-how)[30] or section 1231 assets (patented inventions).[31] The capital gains requirements that there be a sale or exchange,[32] that the property not be held for sale to customers,[33] and that property be held for six months[34] should not be difficult to meet under these circumstances.

Spanish tax law treats outright sales of intangible assets in the same manner as sales of manufactured import goods. If the company escapes classification under the permanent establishment rules and otherwise avoids having more than just "minimum contacts," it may limit its liability to suit in Spanish courts and avoid filing Spanish taxes.[35] The outright sale of intangible assets to unrelated parties would not produce Spanish tax liability

29. Bangs & Creed, *Tax Experience of American Corporations Owning Numerous Patents*, 5 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 199 (1961-1962).

30. Courts have consistently recognized that know-how constitutes property, *see* E.I. Dupont de Nemours & Co. v. United States, 147 F. Supp. 482 (1961). Rev. Rul. 64-56, 1964-1 CUM. BULL. 133, however, requires that legal protection be proved before a secret process can be considered property.

31. Patents have long been qualified as §1231 assets and entitled to capital gains treatment if they otherwise meet all the other tests. *See* Commissioner v. Celanese, 140 F.2d 339 (D.C. Cir. 1944); Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942). The cost or other basis of a patent when it is used in a trade or business or held for the production of income is depreciable over its determinable useful lifetime beginning from its date of grant and extending over its seventeen-year term, unless the patent's useful life can be established by the taxpayer at less than the seventeen years. Treas. Reg. §1.167 (a)-6 (a).

32. The courts have long held that to qualify the transaction as a sale or exchange the transferor must not retain any substantial rights. In the important nontax case of Waterman v. MacKenzie, 138 U.S. 252, 255 (1891), the Court discussed what rights have to be transferred, stating: "The patentee may . . . assign, grant, and convey either, 1st, the whole patent, comprising the exclusive right to make use and vend the invention throughout the United States; or, 2d, an undivided part or share of that exclusive right; or, 3d, the exclusive right under the patent within and throughout a specified part of the United States. . . . A transfer of either of these three kinds of interest is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, with a right to sue infringers. . . . Any assignment or transfer, short of one of these, is a mere license giving the licensee no title in the patent, and no right to sue at law in his own name and for an infringement." *See also* §1235 and the regulations thereunder.

33. Since sales of intangible assets are unusual and nonrecurring in nature, they should qualify as property not held for trade or business. See Dunn, *Tax Considerations in Patent Assignments and Licenses Between Related Corporations*, 16 TAX L. REV. 315, 322 (1961).

34. In the case of inventions, processes, and other rights enjoying statutory protection, the holding period is measured from the time these rights are actually reduced to practice [successfully designed or tested, or from the date they are constructively reduced to practice (patent application date) whichever is earlier]. If the invention is developed by an employee of a corporation, as is usually the case, the employee is obligated to transfer the invention immediately and the holding period begins to run from the date the invention is actually reduced to practice. *See* Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953).

35. *See* text accompanying notes 4-5 *supra* for a discussion of this in terms of exporting operations.

and would gain additional benefit from favorable capital gains treatment under United States tax law. Capital gains rates are particularly desirable because patented inventions and know-how usually have a nominal basis and large profits are to be expected.[36]

Licensing to Unrelated Parties

For practical business reasons a company would seldom relinquish all rights in its patented inventions or know-how regardless of favorable tax consequences. If manufacturing is not desirable, most companies will try to obtain a licensing agreement.[37] This allows the company to retain title in the property by licensing. Then, if default occurs, it will be in a better position to protect its interests.[38] Licensing agreements have the further advantage of being easier to market and exploit. However, a company frequently cannot find a suitable entity willing and able to lease all rights in an invention. This is particularly true today when modern products require several patents or "package licensing agreements," which limit the possibility that all rights can be granted to just one licensee.[39]

Licensing agreements have the added advantage of lending themselves readily to the royalty scheme. Inventions are not easily valued because of the difficulty of predicting the commercial success of a new product. The royalty agreement eliminates the risks of valuation and limits the amount of the licensee's initial investment. The "running royalty" contract also favors the licensor because it spreads tax liability over several taxable years and makes more after-tax dollars available for immediate investment.[40]

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36. Most research and development costs are expensed; only the patent application cost of $30 is capitalized. Bangs & Creed, *Tax Experience of American Corporations Owning Numerous Patents,* 5 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 199 (1961-1962).

37. *Id.* at 200.

38. This is especially important in overseas licensing agreements since protection in Spain lags behind comparable United States practice. By carefully selecting a reputable individual or entity as its licensee, the American company best protects itself. For a good discussion on this point *see* G. Walker, *An Introduction to Patent and Trademark Protection in Spain,* in FOREIGN INVESTMENTS IN SPAIN 25 (1962).

39. The practice of licensing all or a number of an owner's patents in a package has become widespread. In addition to avoiding questions of infringement and bookkeeping, "packaging" is necessitated by the complexity of the technological progress in an area. In fact, know-how is also sold together with the patented inventions and the requirements of licensees and licensors almost invariably call for restrictions to be imposed, instead of the transfer of all rights. *See* E. GOLDSTEIN, PATENT, TRADEMARK, AND COPYRIGHT LAW 343 (1959).

40. This "running royalty" type of scheme should also be used whenever possible, even in nonrecurring types of sales of all rights to the invention. The fact that there is no lump-sum payment will not disqualify the transaction from capital gains treatment. For support of this position *see* United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955); Allen v. Werner, 190 F.2d 840 (5th Cir. 1951). *See also* Rev. Rul. 58-353, 1958-2 CUM. BULL. 408. These cases have held that the transfer, whether by outright assignment or "exclusive" license, can qualify for capital gains treatment.

To qualify as an exclusive licensee, however, substantial rights cannot be retained, as was discussed in note 32 *supra.* The courts have been using the standards set forth in

Before licensing can be conducted, and a Spanish company allowed to obtain foreign currency to pay royalties to the foreign entity, authorization must be obtained from the Spanish Foreign Exchange Institute.[41] In passing on the application the Institute weighs the possibility of obtaining this technology at home, its importance, and, perhaps the most crucial factor, the rate of royalty being demanded. If the rate is too high, approval will not be granted.

Licensing to unrelated parties has several deficiencies, which result from the weaknesses of the Spanish enforcement system.[42] The Spanish registration system does not require a prior examination for a patent to be granted. Since the requirement of novelty refers only to Spain, a Spanish patent can be granted for an invention that has already been patented in another country.[43] Although one can take steps to obtain protection under Spanish law, this may not be practical or afford the desired protection to the foreign investor.

Sales, Licensing and Transfers to Related Parties

Numerous business reasons indicate why licensing is conducted only through related companies. Protection of the technology itself is probably the most important consideration. An American company engaging in foreign licensing activities through related companies should also consider operating through a foreign base company. The advantages of this form of operation are: it allows the parent company to coordinate all licensing agreements in terms of over-all company policy, it reduces administrative costs, and it allows centralized training and servicing of licensees, a crucial aspect of foreign licensing.[44]

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§1235 and the regulations under that section (although these provisions specifically were to apply to individuals and not corporate entities) to determine what are substantial rights. Recently amended Treas. Reg. §1.1235-2(b) (1965) provides: "[A]ll substantial rights . . . does not include a grant of rights . . . (i) which is limited geographically . . . (ii) which is limited in duration . . . to . . . less than the remaining life of the patent; (iii) which is limited to certain fields of use, (iv) which grants . . . less than all the claims or inventions covered by the patent which . . . have value at the time of the grant." Because of these limitations on an exclusive license and because it would be hard to justify not having greater restrictions from a business point of view, royalties from licensing agreements are usually ordinary income. In Commercial Solvents Corp., 42 T.C. 455 (1964), the Tax Court disallowed capital gains treatment to a United States company that had granted exclusive rights to a Japanese company to make, use, and sell the products resulting from the patents, but had retained for themselves the right to export.

Spain does not allow export restrictions to be imposed on local licensees and subsidiaries without specific official approval. If an American company undertakes a comprehensive program of foreign licensing the Commissioner is likely to argue that the assets were held primarily for sale to customers and disqualify the transaction for capital gains treatment. *See* note 33 *supra*. *See* Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955), *rehearing denied*, 350 U.S. 943 (1956).

41. Known in Spain by the initials I.E.M.E.

42. *See* note 38 *supra*.

43. *See* G. Walker, note 38 *supra*.

44. *See* Behrman, *Licensing Abroad Under Patents, Trademarks, and Know-how by United States Companies*, 2 PAT., T.M. & COPYRIGHT J. RESEARCH AND EDUC. 181 (1958).

Operating through a foreign base company also provides special United States tax advantages. The major difficulties encountered in qualifying licensing or sales operations for capital gains treatment are the requirements that the company cannot retain any substantial rights and assets cannot be held primarily for sale to customers. Selling all intangible assets to a wholly-owned foreign base company avoids these requirements. It also prevents the problem of having separate recurring licensing or sales agreements, which the Commissioner may consider as assets held for sale to customers. Because the parent company is dealing with its own subsidiary, all substantial rights could be transferred. Although it appears possible to obtain capital gains treatment on the basis of these provisions alone, section 1249 of the Code, which was passed with subpart F and other provisions severely limiting "loopholes" in foreign activities,[45] converts these transactions into ordinary gain.[46] However, the fact that the parent company could incorporate this foreign base company in a "tax haven" country, where the opportunities for deferral would be greatly enhanced,[47] makes this form of operation very attractive from a tax standpoint, regardless of the fact that capital gains treatment on the sale of intangibles to the base company is denied.[48]

Instead of selling these intangible assets to the controlled foreign entity, the parent company might consider transferring the assets tax-free under a section 351 exchange.[49] Section 367, however, makes it mandatory to obtain an

45. *See* Ross, *The Impact of the Revenue Act of 1962 on Reorganizations and Other Re-arrangements Involving Foreign Corporations*, N.Y.U. 22D INST. ON FED. TAX 761 (1964).

46. Like §482 and many other provisions in the area of foreign activities, §1249 is limited to sales to *controlled* corporations. The rules for determining control differ under §1249 from the rules prescribed by §958.

47. *See* text accompanying notes 18-26 *supra*, which examined export base companies for potential tax advantages. Another advantage of incorporating in these "tax haven" European countries is that they usually have a network of tax treaties that: reduce the rate of withholding on royalties; eliminate some source rule problems by outlining what is considered a permanent establishment; and tend to exclude from taxable income some types of activities, for example, technical services of a temporary nature. Since Spain has not yet entered into any tax treaty with the United States, the significant advantages of operating through centralized licensing companies in a country is apparent. For a further discussion on this matter *see* Diamond, *Licensing Abroad Has Many Advantages Over Direct Investment, a Review by Country*, 21 J. TAXATION 228 (1965); Duffy, *Doing Business Abroad: Use of American Know-How*, N.Y.U. 20TH INST. ON FED. TAX. 1269, 1277 (1962).

48. These sales to a related company must conform to the arm's-length standard of section 482. Proposed Reg. 1.482-2 (d) (2) states that when one party permits another to use intangible property, an "appropriate charge" must be made, either in the form of a lump-sum payment or continuing royalties. Proposed Reg. 1.482-2 (d) (2) (iii) (a)- (1) defines an "appropriate charge" by stating that if a "bona-fide" cost-sharing arrangement does not exist between the parties the Commissioner will allocate to the parent that portion that is out of line. *See* text accompanying notes 11-17 *supra* for discussion of terms of the general application of §482 and the records that should be kept to support transactions with related parties.

49. Rev. Rul. 64-56, 1964-1 CUM. BULL. 133 disallows the transfer of know-how from qualifying as "property" for purposes of §351 (therefore making the exchange transfer taxable) unless the know-how can be legally enforced, and also disqualifies as "property" the transfer of technical information and patents when less than all substantial rights have been transferred. Therefore, this freak interpretation of what constitutes property

advance ruling when there is a section 351 exchange involving a foreign company before this transaction can qualify as a tax-free exchange.[50] To obtain the advance ruling a number of conditions[51] must be met to satisfy the Commissioner that the avoidance of income taxes was not a principal purpose of the exchange. This course of action is both difficult and impractical in light of the detailed and burdensome information requirements that have to be filed to obtain a section 367 ruling and the long waiting period (normally six months) before the Commissioner rules.[52]

Even though sections 1249, 482, and 351/367 make it difficult to transfer, sell, or license low basis assets with a high market value to a foreign entity, a foreign base licensing company operation may still be desirable. By isolating the royalty income from current United States taxation, deferral and a more desirable tax result can be reached through the foreign base licensing company. However, under subpart F[53] unless this company can qualify as an

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limits substantially the manner and type of intangible assets that can be transferred tax free under §351.

50. Section 367 will also apply to transfers of property, as contributions of capital even if no stock is issued or exchanged. Rev. Rul. 64-155, 1964-1 CUM. BULL. 138.

51. INT. REV. ANNOUNCEMENT 66-63, 1966 INT. REV. BULL. No. 40, at 16 outlines those situations where a ruling will be issued. The company must show (1) there is a bona fide business (as distinguished from tax) reason for transferring the assets to the foreign entity; (2) the transferred properties will be used in the active conduct of a trade or business; and (3) the properties involved do not include inventory items, accounts receivables, or installment obligations unless the income element in such assets has been or will be taken into the domestic transferor's gross income prior to or at the time of the exchange. These circumstances render unlikely the possibility of such a ruling being issued.

52. For a good discussion of the applicability of §367 to §351 exchanges *see* Cohen, *Long-Awaited Ruling on Transfer of Know-How Sets Guidelines in Important Areas,* 21 J. TAXATION 38 (1964); Lamp, *Recent Section 367 Rulings: Their Effect on Reorganizations of Foreign Companies,* 21 J. TAXATION 240 (1964); McDonald, *Section 367 — A Modern Day Janus,* 64 COLUM. L. REV. 1012 (1964); Siegel, *Section 367 of the Internal Revenue Code and its Relationship to the Taxation of Certain Transactions Involving Foreign Operations,* 22 FED. BAR J. 109 (1962).

53. Under §954(a)(1) royalties derived by a C.F.C. are generally among the items of foreign personal holding company income that must be included in the gross income of the shareholders of such corporation. However, royalties derived from the active conduct of a trade or business with unrelated parties are excluded. Treas. Reg. 1.954-2(d)(1)(ii) states that an active trade or business is when either (1) the foreign corporation substantially developed, created, or produced the industrial property rights from which income was derived, (2) the foreign corporation added substantial value to property rights it acquired by developing means of making it commercially valuable. The Regulations go on to stress that mere performance of marketing functions will not be considered to add substantial value to the property; nor will the frequency with which the transactions are entered establish the fact that such rents or royalties are derived in the active conduct of a trade or business. It seems clear that under our facts, the royalties would not qualify as being from active trade or business since there is only licensing through the base C.F.C. Section 954(c)(4)(C) provides a second exemption to the general rule that royalties are induced in figuring foreign personal holding company income. Since we are operating through a licensing base company, this exemption is not applicable and therefore these royalties would be taxed currently under subpart F.

"export trade corporation"[54] or find another escape hatch,[55] it will be taxed currently on the royalty income.

If the American company does not consider a centralized foreign base licensing operation necessary in terms of marketing or cost factors, direct licensing should be attempted since in some instances capital gains treatment could be obtained.[56] Indirect licensing in the same company can also be attempted in order to make subpart F inapplicable.[57] In these latter situations, income can be deferred if the company operates in each country through a local subsidiary and reinvests for foreign expansion. However, this avenue has been virtually blocked from a United States tax standpoint.[58] It also appears more doubtful that this result can be reached under Spanish legislation. Although Spain has substantially relaxed its investment laws since the early 1960's, authorization still must be sought in order to obtain more than a fifty per cent participation in a local enterprise. In fact, the Spanish Government does not favor this type of "commercial" operation and would probably deny the authorization. Currently only industrial investments by foreign companies are obtaining the permission to own more than a fifty per cent interest.

MANUFACTURING ACTIVITIES

Manufacturing in Spain for the Spanish Markets

Manufacturing involves more risks and expenditures than any other form of operation. It is, however, the most favored form of operation by American companies interested in foreign expansion and having the resources to undertake this type of venture.[59] Its chief advantages are: the ability to utilize

54. Unless the amount of the technological services, which is "Export trade income" under §971 (b) (2), is very substantial, it would be difficult to utilize this export trade income exemption.

55. Section 954 (b) (3) (A) treats a corporation whose foreign base company income is less than 30% as having no foreign base corporate income. Another escape valve is through §963 and the so-called "Minimum Distributions" exemption; this provision operates if the foreign subsidiary paid substantial foreign taxes, made substantial distributions of earnings, or some of these factors. If this occurs, the company is not taxed on the subpart F income of such subsidiaries.

56. *See* text accompanying notes 45-48 *supra*.

57. *See* note 53 *supra*.

58. Deferral applies to the royalty income, but before the foreign company can enter into licensing agreements it must in some manner transfer the intangible assets to the Spanish entity. The problem is to prevent recognizing United States tax on that transfer. For a discussion of the 351/367 avenue, see note 51 *supra*. It is unlikely that a ruling would be issued since the property transferred would not be used in active trade or business (*see* note 53 for what constitutes active trade or business). Transfers as contribution to capital are also affected by the §367 rules. (Rev. Rul. 64-155, note 50 *supra*). The outright sales to licensing avenue is blocked by §1249 so it seems very difficult to transfer these assets without current recognition of United States tax. This section will also apply to prevent sales or a direct transfer from the United States company at less than arm's-length price.

59. *See* Behrman, *Foreign Investment Muddle: The Perils of Ad Hoccery*, I COLUM. J.

the abundant and economical labor resources of Spain; the benefit from the public image factor of operating as a Spanish company; the circumvention of the quota and duties on imports; and the capability of uniting research and development, production, servicing, and marketing so that the company-wide policy can be effectively carried out.

A United States company will first have to choose between establishing a domestic branch and a Spanish subsidiary. Because of business and tax reasons,[60] most American companies choose to operate through foreign subsidiaries. The next consideration is whether to operate as a wholly-owned entity or to invite Spanish participation.[61] This decision has to be made on the basis of governing legislation,[62] the financial climate,[63] national sentiment, company policy and managerial considerations.[64] Tax advantages of one form of operation over another are generally not the primary decisional factors in this consideration.

In providing the Spanish subsidiary with the necessary resources for operations, the parent company must choose whether to contribute cash alone transfer assets in exchange for the stock,[65] or contribute patents and other intangibles. Part of the required capital may be provided in the form of a loan, although the necessary Spanish Exchange Control approval is unlikely.[66]

OF WORLD BUS. 51 (1965); Wentz, *Corporate Transfers of Intangibles Abroad*, 19 TAX EXECUTIVE 142 (1967).

60. *See* text accompanying notes 9-17 *supra.*

61. Joint ventures have the advantage that they free corporate activity from the impact of §842 and §1249; but it is quite unlikely that sound business judgment and other considerations would be disregarded merely to obtain a more desirable tax structure.

62. In terms of Spanish legislation, there are limitations of foreign ownership (as provided by the Decree Law of July 27, 1959) that must be examined. These laws provide that the amount of foreign ownership in a Spanish enterprise cannot exceed 50% unless prior approval is obtained from the Spanish Government. Since 1959 most applications filed have been granted an allowance of 100% ownership, at least for industrial ventures. There are also several investments in certain industrial areas that are free of any limitation on foreign ownership (Decree of April 18, 1963). Therefore, there seems to be no real impediment against an American company establishing a wholly-owned Spanish subsidiary if the investment would be considered by the Spanish authorities as presenting advantages to the Spanish economy. The Spanish forms of business enterprise include general partnerships, limited partnerships, limited partnerships with shares, corporations, and limited liability companies. American companies generally choose the corporate form known as "Sociedad Anonima" (S.A.), which is very close to the American corporate form. For a discussion of these several forms of business in Spain, *see* TAX AND TRADE GUIDE — SPAIN 33 (1965).

63. For a discussion on financing in Europe *see*: Block, *Eurodollars: An Emerging International Money Market*, NYU GRADUATE SCHOOL OF BUSINESS ADMINISTRATION BULL. April 1966, at 4.

64. Some of these other considerations have already been suggested throughout this article. Each company will weigh these factors in light of its own tactics and over-all commitments. In activities involving patented inventions and know-how an added justification for having a wholly-owned subsidiary is the assurance that these technical secrets will be better guarded and protected.

65. In Spanish practice this is actually not possible, *see* text accompanying notes 71, 72 *infra.*

66. Borrowing in Spain by a foreign-owned company (25% or more) is restricted to 50% of the equity of the company.

Many companies simply "advance" the funds or incur substantial debts from inter-company transactions. Another alternative is for the parent company to sell to its subsidiary some of the assets necessary for the operations of the Spanish entity.

The transfer of assets in exchange for stock in a foreign company may enjoy tax-free treatment under sections 351 and 367. Unlike the transfer to a foreign base licensing company,[67] this transfer involves both a bona fide business purpose for transferring the assets to the foreign entity and a situation in which the properties *will* be used in the active conduct of trade or business. In addition, the American corporation may exclude inventory items, accounts receivable, and installment obligations in order to qualify under the guidelines.[68] In this way, the United States company might obtain deferral of a gain that would otherwise have been recognized.[69] However, the transfer of technical information and know-how presents special problems. Not only must there be proof that the rights are legally enforceably,[70] but the delays and information requirements attendant upon such a transfer might make this alternative undesirable.[71]

Another problem is that although the Spanish investment laws permit the transfer of assets other than cash, the governmental ministry that passes upon the authorization for investments of foreign-owned companies seldom allows the capital of a Spanish company to be constituted of property other than cash. The same applies to purchases of an existing enterprise. Thus, the possibility of transferring "stepped-up" property from the United States for tax advantage is completely frustrated. Even attempts to transfer property not as a contribution to capital, but as a "sale" face the problem of the import regulations and duties. Usually only new machinery is allowed to be imported as a "sale."

Transfers of the technology (patents) can take the form of a direct sale from the United States parent or can be made by direct or indirect licensing. The advantage of the indirect method is that the transaction is arranged to isolate the royalty or sales proceeds from current United States income, thereby accomplishing income deferral. Direct exclusive licensing might be preferred, however, when the parent is dealing with a subsidiary corporation, less than fifty per cent of which is owned by the parent. In this situation, section 1249 would not apply, and the company might receive capital gains treatment on the licensing transactions.[72] Outright sales are not normally uti-

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67. *See* text accompanying notes 44-58 *supra.*

68. INT. REV. ANNOUNCEMENT 66-63, note 51 *supra.*

69. The result of §358(a)(1) is that the amount of depreciation allowed against these assets would be lower; but the current availability of more after-tax dollars is usually considered an advantage, especially in low tax countries such as Spain.

70. *See* notes 30, 49 *supra* where this "property" requirement for §351 purposes is discussed.

71. *See* text accompanying note 52 *supra.*

72. Besides avoiding the impact of §1249, there might be the added difficulty of meeting the other two tests for capital gains treatment, *i.e.* the sale and exchange tests and the requirement that the property cannot be held for sale to customers. *See* text accompanying notes 45-48 *supra* for discussion of these requirements.

lized. Therefore, nonexclusive licensing with the running royalty agreement should be chosen if capital gains are not possible. In this way more protection can be retained by the licensor parent company, and the tax can be spread over the life of the patent or of the royalty agreement.[73] There is no deferral in any of these direct alternatives.

The indirect licensing or outright sales approach can be utilized only when a United States company has assets outside of the country in another related corporation that can be transferred to the Spanish entity. In fact, many American corporations now have research departments in England and Germany, which provide a substantial source of technology for related European companies and even the United States parent.[74] This scheme can be used only by those companies that already have at least some form of existing foreign operations.

Acquisitions of Spanish Going Concerns and Joint-Venture Operations

A favorite alternative of many foreign investors is to acquire an existing Spanish company rather than form a new one. The advantages are primarily related to the "going concern" factor, which is especially important in operations outside the home territory. This form of operation smooths the transition into the very different Spanish business environment, especially if Spanish management can be retained.

However, this alternative contains many problems. Spanish financial records are difficult to obtain and do not disclose the true operations situation. Because of the widespread use of multiple sets of business records and weak internal control practices, the past history of a business is frequently unreliable or undeterminable. Thus, value is uncertain, "hidden liabilities" such as taxes and creditors are difficult to guard against, and problems such as an uneconomical labor force are present in varying degrees in most companies that can be acquired.[75] Acquiring assets to avoid these hidden problems is not a workable alternative because the tax cost is prohibitive.[76] In most cases, therefore, stock is acquired by foreign investors.

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73. *See* text accompanying notes 37-43 *supra.*

74. *See What U.S. Companies Are Doing Abroad — Tapping Talent Overseas,* U.S. NEWS & WORLD REPORT, Feb. 26, 1968, at 60. If the foreign corporation develops patents to be used in the United States, then United States source of income problems arise. *See* §§861-964. For a very good, current discussion of this matter *see Limitations Upon the Use of Shadow Foreign Subsidiaries Tax Act of 1966,* 21 TAX L. REV. 383 (1968). *See also* note 58 *supra* for a discussion of the deferral possibilities of this avenue.

75. Employees cannot be laid off in Spain except for due cause, and even then not "en masse."

76. In Spain there is a 4% transfer tax on the amount of the liabilities transferred. Spanish companies have traditionally carried a very high debt structure. Thus, the cost of transferring the liabilities would be out of the question, and canceling these would be almost always an impractical eventuality. The assets themselves, when transferred, are subject to a transfer tax, capital gains tax, and many other forms of stamp duties, et cetera. The transfer of stock (that is, the purchase by the foreign company of the stock in the Spanish enterprise) is only subject to an approximate tax rate of 2.7% (including transfer

Another consideration is whether to acquire more than a fifty per cent interest in the company. This depends upon the company's policies and objectives, the agreements to be reached, and the possibility of obtaining an authorization from the Spanish Ministry of Government. All of these are of crucial importance to the foreign investor.

Among the practical problems that can arise in conducting a joint venture with Spanish interests is the conflict between local management views and over-all foreign company policies. There should be an understanding from the beginning as to matters such as tax policy. This becomes important in a country such as Spain where tax evasion is very commonplace. The foreign investor cannot convert funds into a foreign currency unless he can prove the payment of Spanish taxes.[77] The use of the Spanish "global method" of taxation as a solution to this problem is often utilized if agreeable to both parties. This system determines the taxpayers' tax base by using an objective approach of allocating the tax burden by industries on factors other than their income. Under this method, "normalization" of the tax situation is made simpler, and the "two-set of books" system can be more readily rationalized by the management of the foreign company.

Loan agreements are also a matter of importance. Spanish credit is very tight and a company with established credit lines becomes a valuable asset. This matter is made even more crucial because present Spanish foreign investment laws provide that a company in which foreign investors own more than twenty-five per cent cannot have a debt structure that exceeds fifty per cent of its equity. This is a very serious limitation in any country, as to almost any type of company. Since this restriction applies only to long-term debts (over eighteen months), revolving loans or long-term loans that are continually extended or renewed can be utilized as a means of avoiding the full impact of these restrictive measures. Foreign banks are prohibited from carrying on banking business in Spain and their influence is greatly limited because foreign companies are not allowed to own more than twenty-five per cent of a Spanish bank. A foreign company with access to established lines of credit through the acquisition of a Spanish company is, therefore, in a very envious position vis-a-vis other foreign companies.

The relationships of the parent foreign company to the Spanish entity should be carefully considered in a Spanish joint venture involving questions of intercompany transactions such as pricing, loans and exports. Additional matters such as marketing policy should be discussed and resolved through the articles of incorporation, bylaws, management contracts and similar agreements. If these difficulties can be solved and a favorable working relationship established, the advantages of Spanish participation in the management can be a very valuable asset.

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taxes and notary fees), and capital gains will usually not be incurred by the seller unless he held the property for less than a year.

77. Foreign exchange rules are rigidly applied in Spain.

Operating Through Two or More Related Companies

A company operating in several countries should attempt to interrelate all its foreign activities so that foreign subsidiaries will complement both the parent and each other. Today more companies are becoming truly international in character. Their organizational structure might contemplate research and development to take place in one country and manufacturing in another, with sales offices in the market areas and a regional central office administering and synchronizing all of these operations in still another country. This approach is economically sound and efficient[78] because it allows a company to select and benefit from the comparative advantages offered by various countries. For example, research and development could be carried on in either the United States, Britain, or West Germany since technical competence is more readily available there; manufacturing could be conducted in Spain because of economical labor and ample human resources; and the central office for Europe could be located in Brussels because of the favorable tax legislation and the international character of that city.

The fact that manufacturing activities are being performed abroad not only allows more flexibility and strength to the overseas expansion efforts of a United States company, but it may also result in a lower tax burden since the impact of subpart F and section 482 might be somewhat mitigated.[79] For companies capable of conducting extensive foreign operations, an interrelationship between exporting, licensing and manufacturing can be very profitable, and with adequate planning the over-all tax burden can also be made more favorable. Mergers, acquisitions or other types of combinations with American or European companies may make it possible to achieve the desired economic size for optimum results.

CONCLUSION

This article has suggested the possible forms of business combinations that can be utilized when a company is contemplating doing business in Spain. It is important to recognize that an appropriate "fit" must be made between the needs and resources of a particular company and the existing United States and Spanish legislation. Through careful analysis and planning an American company can derive multiple benefits from the scope of its activities abroad.

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78. Internal legislation, however, might prevent the utilization of these forms of operations because tariff barriers, exchange controls, border taxes, and other protectionistic roadblocks to free world trade and investment must be contended with.

79. If the company is engaged in manufacturing activities, then it is easier to arrange licensing operations so that the royalty income is "active" and therefore not subject to subpart F. Also, it would be simpler to come under the 30/70 exclusion and the other "escape hatches." *See* text accompanying notes 56-58 *supra*.