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Volume 13
Issue 1 *Issue 1 - December 1959*

Article 4

12-1959

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Recommended Citation

Walter W. Brudno, Tax Considerations in Selecting a Form of Foreign Business Organization, 13 *Vanderbilt Law Review* 151 (1959)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol13/iss1/4

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TAX CONSIDERATIONS IN SELECTING A FORM OF FOREIGN BUSINESS ORGANIZATION

WALTER W. BRUDNO*

I. INTRODUCTION

The provisions of the Internal Revenue Code which are of particular relevance to the planning of foreign operations are few in number and are generally deceptively simple in phraseology. The substantive provisions consist of those sections which specify rules for determining the source of income,[1] for calculating the credit for foreign taxes paid in respect of foreign source income,[2] and for allowance of concessional treatment accorded Western Hemisphere Trade Corporations,[3] United States Possessions Corporations,[4] and China Trade Act Corporations.[5] Measures designed to prevent tax avoidance which are of particular relevance are those which relate to acquisition of corporate control for the purpose of receiving certain deductions, credits or allowances,[6] to collapsible corporations,[7] to participation of a foreign corporation in certain "tax free" exchanges,[8] to reallocation of income and deductions between related corporations,[9] to foreign personal holding companies,[10] and to the special excise tax on the transfer of stock or securities to a foreign corporation, trust or partnership.[11] Despite the apparent simplicity of the statutory pattern, tax planning of foreign operations requires intensive application of both ingenuity and intuition. As to many of the technical problems the statutes are ambignous, obscure or silent. In most situations effective planning requires painful accommodation of practical business needs to the vagaries of a legal framework which is ill-suited to the realities of modern international trade.

No attempt will be made here to describe or analyze the statutes, rulings and cases in this field, the reader's knowledge of which is

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1. INT. REV. CODE OF 1954, §§ 861-864.
2. *Id.* §§ 901-905.
3. *Id.* §§ 921-922.
4. *Id.* § 933.
5. *Id.* §§ 941-943.
6. *Id.* § 269.
7. *Id.* § 341.
8. *Id.* § 367.
9. *Id.* § 931.
10. *Id.* §§ 551-558.
11. *Id.* § 1491.

assumed.[12] Our present task is to extract from this thorny, and sometimes impenetrable thicket, the basic criteria to guide in designing a structure for the conduct of a particular foreign enterprise. We can provide only criteria, and not a formula. For each operation is unique and the ultimate form will be dictated by the nature of the business, the area in which operations are to be conducted, the financial needs and operational objectives of the enterprise, and the policies and viewpoints of management—both rational and irrational.

The present discussion will assume, unless otherwise noted, that the domestic enterprise is conducted in corporate form and that the foreign enterprise will be an extension of the corporation's domestic activities within the framework of the basic corporate structure. However, where the corporation is closely held, there exists the possibility of direct ownership of the foreigu vehicle by the shareholders of the domestic one, a possibility which should not be overlooked.

A. Distinction Between Form and Method

At the outset it is necessary to distinguish between the form in which a business is conducted and the method by which it is conducted. Form is a matter of legal structure, method is a matter of operating procedure within the confines of that structure. For example, a decision to sell abroad through a foreigu domesticated subsidiary, rather than through a foreign branch, is a decision as to form; a decision to sell goods to the foreigu subsidiary for resale by it, rather than to employ it as agent to sell the goods on commission, is a decision as to method.

While the nature of the legal structure will limit to some extent the available operating methods, there are a variety of methods that may be employed within the confines of any given structure. Often the strictures of the particular form can be made less onerous by selection of an appropriate method. Equally often, the method has been predetermined by the business requirements and objectives and the form must be accommodated to it. Thus, if it has been decided that the foreign activity will be confined to the licensing of foreign manufacturers and the provision of technical assistance to them, the method is fixed, but the form through which licensing and assistance is rendered may be directly by the U. S. corporation or its branch, by a domestic subsidiary, or by a foreigu subsidiary.

B. Form and Function

In selecting a particular form, it is imperative that the form be both functional and functioning. A form of operation which results

12. See Brudno, *United States Taxation of Income from Abroad*, in INSTITUTE ON PRIVATE INVESTMENT ABROAD (1959).

in uneconomic distortion of normal business procedures may delight the tax theoretician but it will hardly satisfy his client. A form of operation which is not a functioning reality is not worth the trouble and expense of creating and maintaining it, for it is foredoomed to failure. No form should be selected unless the businessman who will have to live with it is convinced that he can live with it and is determined that he will do so.

Too often, in the excited anticipation of tax bonanzas, a business will adopt a form of foreign operation which is not compatible with business realities; inevitably, the exigencies of doing business will then cause either deliberate or casual violation of the legal requirements for achieving the tax objectives of the selected form. For example, an enterprise requiring a high degree of technical skill may establish a separate subsidiary for foreign exploitation of that skill, when the only personnel capable of doing the work cannot be separated from the parent. Tortuous methods may be devised so as to create the illusion that the subsidiary is fulfilling its designated function, but the form and function are alien to each other and the business efficiency or the tax security, or both, will suffer as a consequence.

C. Available Forms

The forms available for conduct of a foreign enterprise range from direct export without any foreign establishment, to substantial duplication of the domestic operation in a separate, foreign incorporated subsidiary. Basically, there are but three possible forms: Branch, domestic subsidiary, and foreign subsidiary. But a branch may be that of the parent, of a domestic subsidiary, or of a foreign subsidiary; the domestic subsidiary may be an ordinary corporation, a Western Hemisphere Trade Corporation, or a United States Possessions Corporation; and the foreign subsidiary may be organized in the country in which operations are conducted or in a third country where there are little or no operations, or it may be a subsubsidiary of either of these. The alternatives are increased by the fact that a foreign subsidiary may be cast in any one of a variety of forms permitted by the laws of the foreign country involved, and are still further increased by the possible desirability of fragmenting the foreign enterprise into its several component activities, with each component to be conducted through a separate entity. In planning the structure of most foreign operations, it is necessary at least to consider each of these alternatives.

D. General Considerations in Choice of Form

1. United States Considerations.—From the United States tax standpoint, the basic objectives in choosing a form of operation are

to choose that form which, together with the method to be employed, will accomplish one or more of the following:

(a) Prevent taxation of the same income by the United States and by a foreign government without full credit for the foreign tax against the United States tax.

(b) Permit maximum utilization of such deductions, credits, exclusions and exemptions as are available under United States tax law in respect of foreign income.

(c) Produce the lowest ultimate tax burden on the foreign income.

(d) Postpone as much tax as possible until repatriation of the foreign income.

In a particular case, it may be necessary to accommodate the form to special requirements of the Export Import Bank or the International Cooperation Administration, or of regulatory measures governing special types of business, or of provisions of state law, or of the corporate charter, or of the term loan agreement, etc., applicable to the particular corporation.

2. *Foreign Considerations.*—From the standpoint of foreign law, the basic tax objectives are similar, and to some extent complementary, to the above. In addition, there may exist one or more of the following objectives:

(a) To insulate the United States enterprise from foreign tax and legal jurisdiction.

(b) To qualify the foreign enterprise for such tax or other concessions or privileges as exist in the foreign country.

(c) To minimize income, import, export, excise, turn-over and other taxes.

(d) To avoid tax or legal discrimination.

(e) To mitigate the effects of exchange control.

(f) To minimize the risks of devaluation and expropriation.

Sometimes the form necessary to achieve the foreign objectives is incompatible with that necessary to achieve the domestic ones, or some of the domestic or the foreign objectives can be achieved only at the sacrifice of others. In such cases, it is usually necessary to decide which objectives to seek and which to abandon. In some cases, it may be possible to salvage some of the threatened objectives by adopting a combination of several forms and allocating the component activities of the foreign operation among them.

Since taxation is our subject, only passing mention will be made to the non-tax factors bearing upon the choice of form, although often these may be material or even of paramount importance.

II. Direct Export

The simplest form of foreign operation is direct export by the principal enterprise with, at most, adjustment of the internal structure by establishment of an export department or division within the corporate framework. While this form has the virtue of simplicity, it is generally suitable only for pure export business with no foreign establishment and with a minimum of direct customer contact outside the United States. Where there is any type of establishment abroad or where domestic personnel make frequent business trips into the foreign territory, there is serious danger that the foreign country will impose tax on a portion of the profit (either actual or estimated) and that such tax will not be allowed as a credit against United States tax. In such direct export operations, it is usually not practicable to pass title to the goods abroad, with the result that there will be no foreign source income,[13] the numerator of the per country limitation fraction[14] will be zero, and the creditable tax will be zero. It is not possible to generalize as to the extent of foreign activity or contact which will give rise to foreign tax liability as there are wide variations among the laws of the different countries. In India, for example, a mere "business connection" in the nature of an exclusive agency contract may be sufficient to generate tax although the United States taxpayer never sets foot in the country;[15] in Pakistan the rule was the same until the recent treaty substituted the more equitable and predictable permanent establishment test.[16]

Establishment of a mere export division or department, of course, produces no mitigation of United States income taxes since the entire

13. Income from the purchase of goods in the United States and their sale abroad is treated as derived from sources in the country in which the goods are "sold." Int. Rev. Code of 1954, § 861. The place at which goods are sold is considered to be the place where title thereto (beneficial ownership and risk of loss) passes to the purchaser. Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 297 U.S. 306 (1929); United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), *cert. denied,* 352 U.S. 968 (1957); American Food Products Corp., 28 T.C. 14 (1957); Ronrico Corp. v. Commissioner, 44 B.T.A. 1130 (1941); Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297 (1941), *aff'd,* 127 F.2d 260 (5th Cir. 1942); East Coast Oil Co., S.A. v. Commissioner, 31 B.T.A. 558 (1934), *aff'd,* 85 F.2d 322 (5th Cir. 1936), *cert. denied,* 299 U.S. 608 (1936); Briskey Co. v. Commissioner, 29 B.T.A. 987 (1934), *aff'd,* 78 F.2d 816 (3d Cir. 1935); R. J. Dorn & Co. v. Commissioner, 12 B.T.A. 1102 (1928), *acq.,* VIII-1 Cum. Bull. 13 (1929); Treas. Reg. § 1.861-7(c) (1957).

14. Int. Rev. Code of 1954, § 904(a).

15. Indian Income Tax Act of 1922, § 42(1).

16. Tax Convention With Pakistan, July 1, 1957 art. III (1). Executive N. 85th Cong., 1st Sess. (1957).

export income is taxable to the principal enterprise as earned.[17] The principal tax problem in use of this form is to ensure that the export income will be free of foreign tax or that any foreign tax which is imposed will be fully creditable against United States tax.

Some of the largest United States exporters have used a variant of the direct export form by establishing a separate United States subsidiary to conduct their worldwide export operations.[18] Aside from the additional tax on inter-corporate dividends, it makes no difference taxwise whether export operations are conducted by a parent corporation or by a separate United States subsidiary, unless that subsidiary is qualified as a Western Hemisphere Trade Corporation or as a United States Possessions Corporation. This form may provide some insulation of the parent against liability in the foreign jurisdiction and may accomplish some reduction in state franchise or other taxes. However, the decision to use this form has generally been motivated by managerial rather than by tax or legal considerations and frequently the basis for such organization is more historical than rational. Some of these corporations sell to their export subsidiaries at a price which is sufficiently high to assure that the subsidiary will earn little, if any, profit. The Internal Revenue Service does not seem to object to this procedure inasmuch as it is generally a matter of indifference whether the income is taxable to the one corporation or the other. However, if the subsidiary should be subjected to foreign tax liability it has stripped itself of any basis for claiming credit for the foreign tax. While there is generally some room for argument as to what should be included in the foreign income element of the limiting fraction, that is in the numerator, it would be difficult indeed to argue that the total income element, the denominator of the fraction, should be other than zero where the corporation has deliberately structured its operations so as to produce that result.

III. BRANCH

A. Types of Branches

The branch form is similar in some respects to the direct export form, except that the United States corporation has committed itself more explicitly to economic penetration abroad by firmly implanting its foot on foreign soil. A branch, of course, is capable not only of participating in export operations but also of carrying on every phase of the corporate business within the foreign country including

17. Cook v. Tait, 265 U.S. 47 (1924).

18. *E.g.*, Socony Mobil Overseas, Norton Behr-Manning Overseas, Westinghouse Elec. International, International General Elec. Co., Inc., General Motors Export Co., Abbot Laboratories International Co., Coca-Cola Export Sales Co., Crane Export Corp., Goodyear Tire & Rubber Export Co.

selling, rendition of services, assembly of products, manufacturing, and licensing.

It is common to think of a branch in terms of a foreign complex of facilities and personnel directly responsible to the principal United States Office, and without separate legal identity. However, a branch may be a tributary of any subsidiary of the principal corporation, whether that subsidiary be domestic or foreign. Thus the question frequently arises as to whether a foreign base company[19] should penetrate the country of actual business operations by means of a branch or of a subsidiary of its own; or whether an operating subsidiary domesticated in one country should extend its operations into other countries through a branch, its own subsubsidiary, or a sister subsidiary of the parent.

B. Advantages and Disadvantages

Usually a branch is required to register or qualify to do business in the country in which it is established, and not infrequently the registration requirements are almost identical to those for local incorporation.[20] It is almost inevitable that a branch will be subjected to tax in the foreign country, inasmuch as virtually every country with an income tax assesses income which is either derived from or through a physical establishment within the country or which is derived from business done within its borders. In some cases the mere maintenance of a branch for the purpose of purchasing goods within the country will not generate income tax liability,[21] although some countries would even attribute taxable income to this type of a branch.

In some countries branch books must be kept in accordance with the corporate accounting requirements of local law and the books are accepted as the correct measure of taxable income unless there is evidence of arbitrary pricing or other arrangements in dealings between the principal office and the branch.[22] In others, the branch income is determined by objective, and often unrealistic standards, which may have little or no relationship to the amount of profits allocated to the country for United States income tax purposes. For example, the taxable income attributed by the foreign country to

19. See text accompanying note 41 *infra*.

20. For summary of basic requirements, see, *e.g.*, United States Department of Commerce, Bureau of Foreign Commerce, INVESTMENT IN MEXICO: CONDITIONS IN OUTLOOK FOR UNITED STATES INVESTORS (1955), and other monographs prepared by the Bureau of Foreign Commerce giving investment information for such countries as Australia, Ecuador, Nigeria, Paraguay, Peru, the Philippines and Turkey.

21. This principle is incorporated in every double taxation convention to which the United States is a party.

22. *E.g.*, Brazil, Reg. art. 34; GUMPEL & DE SOUSA, TAXATION IN BRAZIL 112 (Harvard Law School, 1957).

the branch operations may be determined arbitrarily as a flat percentage of gross receipts[23] or as a percentage of net world income weighted by such factors as the ratio of branch salaries to total salaries, branch expenses to total expenses, branch assets to total assets, etc. The allocation formula may require full disclosure of the corporation's entire world income and world assets.[24]

In some countries, no deduction may be taken for expenses incurred outside the country, whether those expenses are directly related to the business of the branch or reasonably allocable thereto.[25]

Where a country's industrial incentive laws allow rapid depreciation of capital facilities, the foreign tax may be considerably lower than the United States tax in the first few years of operation and higher in the later years.

In all of these situations loss of credit for foreign tax may result due to the distortion of the numerator of the per country limitation fraction. While the carryover and carryback of foreign taxes in excess of the allowable credit was designed to mitigate the effect of such distortion,[26] this provision is of little benefit where the distortion is recurrent year after year and always in the direction of overstatement by the foreign country of income subject to its tax.[27]

In evaluating the desirability of foreign branch operation from the standpoint of foreign law, the peculiar hybrid status of branches under the laws of certain civil law countries must be taken into account. In some countries a branch may be treated for most purposes as though it were a separate legal entity and for tax purposes may be treated in most respects as though it were a corporation. Once having taxed the branch as a corporation, the separate entity theory is abandoned and the entire branch income is again taxed as though it had been distributed as a dividend to the principal office, on the ground that the branch is an integral part of the entire corporate entity.[28] On the other hand, it may be desirable to operate in some countries either through a branch of the U. S. corporation or of a subsidiary organized in some third country in order to avoid tax on dividends imposed by the country of operations. The choice between branch and subsidiary operation may also be influenced by differences in the treatment of the forms by the particular country for excess

23. *E.g.*, Mexico: Ley del Impuesto sobre la Renta, arts. 189, 193; GUMPEL & DE SOUSA, TAXATION IN MEXICO 289 (Harvard Law School, 1957).
24. This is the practice in Switzerland.
25. Generally this treatment prevails when the tax is not imposed on income from foreign sources. *E.g.*, Venezuela.
26. INT. REV. CODE OF 1954, § 904(c).
27. In such cases the foreign tax will generally exceed the limitation in all years, leaving no room for absorption of unused credit carried over from prior years.
28. See, for example, TAXATION IN BRAZIL, *op. cit. Supra* note 22, at 213 (1957).

profits tax,[29] undistributed profits tax[30] or other purposes.

One of the most frequently expressed objections to foreign operation through a branch is that a United States corporation is directly subjected to the tax and legal jurisdiction of the foreign government. The objection undoubtedly has some merit although there is no evidence that any United States corporation has been exposed to expropriation of assets other than those located in the particular foreign country. The principal danger of branch operation from a jurisdictional standpoint is that the foreign government's scrutiny of the corporate affairs may not be limited exclusively to the affairs of the branch. Also, of course, the corporation's liability in contract or tort is not limited by the amount of its branch assets.

From the United States' standpoint, the income of a foreign branch is taxed when earned, with allowance of credit for foreign tax within the applicable limitations. Where the effective foreign rate is as high as or higher than the effective United States rate, no disadvantage is presented since the credit will eliminate the United States tax liability and the only tax paid will be the foreign tax. Where the effective foreign rate is lower than the effective United States rate, the difference will be absorbed immediately by the United States tax and no benefit will be obtained from the favorable tax situation which may prevail in the particular foreign country.[31] Where branches are maintained in two foreign countries, in one of which the effective rate is higher than the United States rate and the other of which the effective rate is lower, the United States corporation will bear the higher foreign rate on its income from the first country and the higher United States rate on its income from the second country.[32] Thus, if one country's effective rate is 60% and the other country's effective rate is 44%, and the earnings in each country are exactly the same, the effective total foreign taxes on the foreign income are at the rate of 52%, but a United States corporation will pay 52% on half the income and 60% on the remaining half, or an effective total rate of 56%.

The principal United States tax advantage of branch operation arises where the branch sustains a loss. Such a loss may be set off directly against United States income and the immediate tax benefits thereof obtained.[33] If a loss is sustained by a branch in one country,

29. Mexico: Ley del Impuesto sobre la Renta, art. 172; TAXATION IN MEXICO *op. cit. Supra* note 23, at 334 (1957).

30. Mexico: Ley del impuesto sobre la Renta, art. 138, § VII; TAXATION IN MEXICO, *op. cit. Supra* note 23, at 323 (1957).

31. This result has generated wide-spread criticism and is responsible for the "Tax Sparing" provisions originally incorporated in the treaty with Pakistan, *supra,* note 16, and in the pending treaty with India.

32. This is a direct consequence of the "per country limitation" of INT. REV. CODE OF 1954, § 904(a).

33. Comparable setoff can be obtained by use of any type of domestic sub-

and a profit by a branch in another, deduction for the loss is still available in full without impairing the right to credit foreign tax paid on the income of the profitable branch.[34]

In general, except where losses are anticipated, a foreign branch of an ordinary United States corporation represents a suitable form only where the effective foreign rate is comparable to the effective United States rate. The branch form is particularly suitable to extraction of natural resources abroad[35] since it is the only form which preserves the right to United States depletion allowances[36] and the deduction for intangible expenses.[37] Many United States corporations operate in Canada through a branch since the rate of corporate tax in Canada is only slightly below the United States rate.[38] However, each situation must be independently analyzed as there remains the risk that Canada will allocate to itself[39] a greater amount of income than is allocated thereto by the United States with the result that the effective Canadian rate when measured against taxable United States income may be higher than the United States corporate rate.

A Western Hemisphere Trade Corporation or a United States Possessions Corporation must conduct most of its foreign activities through a foreign branch because of the requirement that the bulk of their incomes must be from the active conduct of a trade or business[40] and dividends, of course, would not represent qualifying income.

IV. FOREIGN SUBSIDIARY

There are two basic types of foreign subsidiary, the so-called "foreign base" company or "profit sanctuary" company or "tax haven" company, and the foreign operating company, although there are numerous variants of each.

A. "Foreign Base" Company

A "foreign base" company is one which is organized under the

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sidiary but not by use of any type of foreign subsidiary, since only domestic corporations are includable within an affiliated group. INT. REV. CODE OF 1954, § 1504.

34. However, if the loss reduces the over-all effective United States rate below that of the country in which a profit is realized less than full credit will be obtained for the latter's tax.

35. See Brudno, *Tax Consideration in Foreign Oil Operations*, NINTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION, Matthew Bender and Co. (1958) for a detailed discussion of the problems peculiar to natural resource extraction abroad.

36. INT. REV. CODE OF 1954, §§ 613, 614.

37. Proposed Treas. Reg. § 1.612-4(a) (1).

38. Current income tax rate in Canada is 47% plus 3% social security tax.

39. See International Harvester Co. v. Provincial Tax Commissioner, [1949] A.C. 36 (Sask.); Provincial Treasurer of Manitoba v. Wm. Wrigley, Jr. Co. [1950] A.C. 1 (Man.).

40. INT. REV. CODE OF 1954, § 921.

laws of some foreign jurisdiction which either imposes no income tax or which imposes income tax at a low effective rate, or which exempts from tax the foreign income of its domestic corporations, or which taxes such income at concessional rates, and which also imposes little or no capital or other taxes.[41] Generally, though not invariably, a foreign base company cannot conduct active business operations within the country of its domestication, and its activities there are confined to the performance of managerial and administrative functions in respect of active operations in one or more other foreign countries. A foreign base company may be either a pure holding company, with active operations conducted entirely by its subsidiaries in other countries, or it may carry on business in other countries through branches or agents, or it may carry on a part of its operations through subsidiaries, and part through branches or agents.

1. Advantages and Disadvantages.—The advantages of a "foreign base" company can be described briefly as insulation of foreign earnings from United States taxation,[42] homogenization of foreign earnings and taxes for purposes of the foreign tax credit,[43] and extreme flexibility in accommodating both form and method of foreign operations to achieve the most favorable results under both United States and foreign law. Many supplemental advantages may be obtained in a particular situation.

Undoubtedly, insulation of foreign earnings from United States taxation has provided the principal motivation for the establishment of most foreign based companies. The foreign income of a base company (which is not a foreign personal holding company[44]) is not subject to United States tax unless it is transferred to the United States parent corporation as dividends, interest, royalties, or as a liquidating distribution. The income of subsidiaries of the base company can be transferred freely from the subsidiary to the base company and from the base company to another subsidiary without diminution by United States income tax thereon. Surplus funds which are not immediately needed in any of its foreign operations may be accumulated by the base company without risk of imposition of the United States tax on unreasonable accumulation of earnings.[45]

41. GIBBONS, TAX FACTORS IN BASING INTERNATIONAL BUSINESS ABROAD (1957).

42. The taxable income of a foreign corporation not engaged in trade or business in the United States includes only "fixed or determinable" income such as interest, dividends, rents, etc. INT. REV. CODE OF 1954, § 881(a). Other earnings may be subjected to United States tax against a parent or affiliated company if inter-company transactions are not on an arms-length basis. INT. REV. CODE OF 1954, § 482.

43. See text accompanying note 47 *infra*.

44. INT. REV. CODE OF 1954, § 551.

45. INT. REV. CODE OF 1954, § 531. Since the tax is measured by "accumulated

It is clear that the "insulating effect" of base company operation is beneficial only where the income which is insulated from United States tax is subjected to foreign taxes which are significantly lower than the effective United States rate. As the foreign rate approaches the United States rate, the advantage diminishes since, with credit for the foreign tax, only the difference between the two rates would be payable to the United States if foreign operations were conducted directly by the United States corporation or its branches. Consequently, where actual operations are to be carried on in a country which would subject the income to a relatively high rate of tax, establishment of a foreign base company is generally not justified purely on tax grounds.

The insulating effect of a base company may permit more rapid expansion of foreign operations than would otherwise be possible and may reduce materially the seriousness of special hazards to which foreign operations are exposed. To the extent that low taxed foreign income can be freed of United States tax, additional funds are made available for additional promotional activities or reinvestment abroad for the purpose of expanding the foreign operation. Insulation from United States tax may also shorten materially the period for recovery of money placed at risk in a foreign environment. For example, if the net profit before taxes of a particular foreign operation is 20% of investment and the foreign earnings are fully subject to United States tax, the pay-out period will be approximately ten years. If such earnings are insulated from United States tax and if they are not taxed by the foreign country, the pay-out period will be reduced to five years. Thus, the industrial incentive laws in force in many foreign countries, which have the effect of materially reducing or eliminating the foreign income tax during the early years of operation, may have a positive effect where a base company operation is used, whereas such legislation will have no effect where the activity is carried out by a branch of a United States corporation or by a subsidiary domesticated in the country of operations which pays out most of its earnings by way of dividends.[46] By operating in such countries through either a branch or a subsidiary of a base company, it is not only possible to obtain immediate benefit from the available tax concessions but also to minimize the risk of currency depreciation or blockage of funds, since the profits may be withdrawn by the base company and converted into hard currencies or reinvested elsewhere.

The second benefit of operation through a foreign base company to which I referred, "homogenization" of foreign income and taxes for purposes of the foreign tax credit, stems from the convenient

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taxable income" a foreign corporation with no United States taxable income would be immune from the tax.

46. See note 31 *supra*.

fiction adopted by the Treasury Department that all earnings of a foreign subsidiary will be treated as though they arose within the country of its domicile and all income taxes paid by it will be treated as though paid to the country of its domicile.[47] As a result, foreign tax rates which exceed 52% are offset against foreign tax rates which are less than 52% and the combined effective rate of all foreign taxes on all income of a subsidiary may be reduced to a level which does not exceed the amount allowed as a credit within the per country limitation.

However, this homogenization is not an unmixed blessing. If a foreign base company conducts any of its operations through a branch, a loss of the branch will be set off against income from other branches or dividends from its subsidiaries. The effect will be exactly the opposite of what is desired since the ratio of total taxes to total net profit will be increased and may actually produce a loss of credit due to a resultant effective average rate of tax which is higher than the United States effective rate. To give a simple example, assume that the foreign base company's branch in country A earns a profit of $1,000 dollars on which it pays tax of $300 to country A. Assume that its branch in country B sustains a loss of $500. The base company will have a combined net income of $500 upon which it is considered to have paid tax of $300, an effective rate of 60%.

Another disadvantage of this homogenization is that high taxes paid to one country, but within the limits of the per country limitation, are diluted by low taxes paid to another, so that payment of dividends by the base company to its United States parent will entitle the parent to a credit based upon the lower average rate. The parent will never receive the full benefit of credit for the tax which has been imposed at the higher rate until such time as all the earnings for the year have been distributed by the base company.[48] For this reason, it may be desirable for the United States corporation which expects to receive more or less regular dividends from its foreign operations to place its operations in high tax countries and in low tax countries in different foreign subsidiaries. In this manner, the dividends may be drawn off from the subsidiary with the higher effective tax rate and the maximum current benefit of the foreign tax credit obtained.

Despite the several disadvantages of operations of a foreign base company which I have mentioned, this form is eminently suitable to the conduct of foreign business in countries where the rates of tax are relatively low, provided the form is consistent with the func-

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47. Treas. Reg. § 1.902-1(c) (1958).

48. Dividends are treated as paid out of the most recently accumulated earnings and profits and then out of the earnings and profits of prior years in inverse order. INT. REV. CODE OF 1954, § 901(c). See Tax Form No. 1118.

tional needs of the business.

2. *Selection of Country.*—The tax requisites for a suitable place of incorporation of a foreign base company have already been mentioned. The countries which have been most popular for this purpose are the Bahamas, Bermuda, Panama, Liechtenstein, certain cantons of Switzerland, and Liberia. Liberia has been used principally by shipping companies[49] not only because of its favorable tax position but also because of favorable laws and regulations governing the operation of ships flying its flag. Canada has been popular as a seat of operations for foreign base companies due to special tax exemption of the foreign income of so-called "foreign business corporations." However, recent amendments to the Canadian Income Tax Act deny the exemption to corporations which did not qualify for it prior to April 10 of this year.[50]

There are many other countries which, solely on the basis of their tax climate, are suitable for foreign base company operation. Venezuela has been used by a number of companies, principally those with substantive operations there, in view of the fact that Venezuela does not tax the foreign income of resident corporations.[51] However, recent increases in the rates of Venezuelan tax,[52] while not eliminating the advantage, reduce it materially. Belgium is sometimes used as a base of operations in Europe inasmuch as the foreign income of a Belgian corporation is taxable at only one-fifth the normal corporate rate.[53] The Netherlands is also sometimes used as a base for European operations inasmuch as dividends from a foreign subsidiary of a Netherlands corporation are exempt from the Netherlands corporation tax if the subsidiary is subject to foreign income tax.[54] Australia may be used for base company operation provided business outside Australia is conducted through a branch of the base company, since Australia does not tax foreign income, other than dividends, which is subject to any income tax where earned.[55] The United Kingdom does not tax the foreign income of a non-resident corporation,[56] and a corporation may be organized in the United Kingdom and still qualify as a non-resident if its management and control

49. See Baker, *Flags of Refuge for the Shipping Industry,* 13 Tax L. Rev. 137 (1958).
50. Finance Act 1959, § 19; Income Tax Act, § 71(5).
51. Ley del Impuesto sobre la Renta, art. 1.
52. Decree 476, Dec. 19, 1958.
53. Consolidated Income Tax Law, art. 35, par. 11.
54. Company Tax Decree, art. 10.
55. Income Tax and Social Services Contribution Assessment Act, § 23(q). See Brudno, Taxation in Australia (1958). Published by Little, Brown & Co. as part of the Harvard Law School World Tax Series.
56. Colquhoun v. Brooks, 2 Tax Cas. 490 (H.L. 1889). See Brudno & Bower, Taxation in the United Kingdom 342 (1957) (Harvard Law School World Tax Series. Little, Brown & Co.).

are not situated there.[57]

The above list of countries whose tax laws make them potentially suitable for base company operation is by no means exhaustive. But it will indicate the variety of tax conditions which may provide a potentially favorable situs for a foreign base company. In addition to the tax considerations bearing upon the selection of a situs for a foreign company there are many other factors relevant to the decision as to the place of incorporation. Among these are the political and economic stability of the country, the convenience and flexibility of its corporate and business laws and the position of the country's currency vis-a-vis that of other countries as the result of bilateral or multilateral currency clearing agreements.[58] In addition, there should be considered such practical factors as the proximity of the country to the United States and to the base company's major markets, the adequacy of transportation and communication facilities, the availability of adequate banking and other business services and of competent office personnel, and the suitability of the country as a place of residence for United States personnel who will be transferred to the base company, including the cost of living, the availability of living accommodations, adequacy of schools, existence of an American colony in the area, and the nature of the climate and the general environment. The importance of these miscellaneous factors should not be underestimated, for, while a favorable tax environment is the *sine qua non* for establishment of a base company, a plan of operation which does not take into account these other factors is only theoretically favorable and will not function in practice.

Depending upon the nature of the business which the foreign base company will represent in the area in which it will operate, there should be considered the advantages of domestication in one of the numerous free port areas of the world or of operation there through a branch or subsidiary of the base company. Some form of free trade zone exists in almost every major marketing area of the world.[59] Most of the zones are designed primarily to provide facilities for the warehousing, processing, assembly, and exhibit of goods free of customs duties and administrative inconvenience until such time as the goods are actually imported into the host country. However,

57. Cesena Sulphur Co. v. Nicholson, 1 Tax Cas. 99 (Ex. 1876); DeBeers Consolidated Mines, Ltd. v. Howe, 5 Tax Cas. 198 (H.L. 1906).

58. The status and principal features of such agreements are reported in INTERNATIONAL MONETARY FUND, 10TH ANNUAL REPORT ON EXCHANGE RESTRICTIONS (1959).

59. See FREE TRADE ZONES OF THE WORLD, World Trade Information Service, Bureau of Foreign Commerce, United States Department of Commerce, pt. 2, No. 56-69 (1956).

some of the free trade zones, such as the Grand Bahamas Freeport[60] and the Free Zone at Colon, Panama, provide exemptions from income and certain other taxes.

3. Selection of Method.—The method of operation to be employed by a foreign base company will depend upon the nature of the particular business involved and the tax and legal requirements of the United States, the country of domestication, and the countries of actual operation. Fundamental to any method of operation is the requirement that dealings between the United States parent and the base company be on an arm's length basis and that any income diverted from the parent to the base company can be justified as reasonable in the light of the functions actually performed by the base company.[61] The following are the principal methods of operation generally available to a base company or its subsidiary, although other methods can be devised to accommodate the operation to the requirements of the particular situation. Also, a combination of two or more of these methods may be dictated by the particular circumstances.

(a) The base company may purchase goods from the United States parent and resell them to its foreign customers. Under this method, title to the goods should pass in the United States from the parent to the subsidiary and outside of the United States, from the subsidiary to the foreign customer, in order that the subsidiary will be insulated from United States tax[62] and the parent may be insulated from foreign tax. Where the subsidiary is not otherwise carrying on activities in the customer's country which will subject it to tax there, it may be necessary to arrange for technical passage of title both outside the United States and outside the country of destination, if the foreign country will assert tax jurisdiction solely on the basis of passage of title within its boundaries. Arrangements for passage of title should also take into account the effect of passage of title within the foreign country upon liability for sales, gross receipts or similar taxes, upon the responsibility for procuring import licenses and complying with customs requirements, and upon the rate of exchange applicable to the transaction.

In lieu of shipping the goods directly to their ultimate destination, the base company, or its subsidiary, may carry an inventory of its own either in the base country, in a free port area, or in the country in which the customers are located.

(b) The company may act as selling agent for the parent and be compensated for its services on a commission basis. This method has

60. The Hawksbill Creek, Grand Bahama (Deep Water Harbor and Industrial Area) Act, 1955.
61. INT. REV. CODE OF 1954, § 482.
62. See note 13 *supra*.

the advantage of avoiding most of the title passage problems inherent in the purchase and resale method, since the parent can pass title at its works or at the port of embarkation direct to the ultimate customer. Since the income of the subsidiary is derived from the performance of services outside the United States,[63] the place of title passage is irrelevant to its United States tax liability.

(c) The company may act as the licensing representative of the parent, using its own personnel to find foreign licensees, negotiate license agreements, provide technical assistance to the licensees in the manufacture of the products, supervise compliance of the licensees with their contractual obligations, etc. In addition, the subsidiary may arrange with the licensee to purchase the manufactured products for resale in designated areas or it may sell the products on behalf of the licensee for a commission.

(d) The company may undertake the assembly of the parent's products, purchasing the necessary materials and components from the parent or others. Then it may resell the products to local distributors or it may sell them through its own sales facilities.

(e) The company may undertake the assembly or manufacture of the parent's products by subcontracting the work with a local factory.

(f) Under any of the above methods, the company may provide field service and repair facilities to ultimate users of the product involved.

(g) The subsidiary may act as purchasing representative for its parent, thereby supplying to the parent goods needed by it for its United States operations, being compensated either by a commission or by a resale profit.

In short, the foreign base company or its subsidiaries may perform abroad virtually every function and service which the parent might otherwise perform for itself.

4. Withdrawal of Earnings.—As previously mentioned, a foreign base company can accumulate its foreign income free of any liability for the United States tax on unreasonable accumulation of earnings. Within the limits of the "thin incorporation" rule, it may be desirable to capitalize the base company with a minimum amount of stock and a maximum amount of debt. This will permit recapture by the United States parent of a significant portion of its initial investment, without United States tax. The capital committed to the foreign environment will then be largely that which has been derived from foreign earnings. As an alternative, it may be desirable to finance the base company's operations with foreign borrowings to

63. The source of income from services is the place where the services are performed. INT. REV. CODE OF 1954, § 862(a)(3).

the maximum possible extent. Such financing will reduce the risk of foreign inflation since the amounts borrowed in the foreign currency will be repayable in the same number of currency units notwithstanding the fact that the value per unit may be materially reduced by inflation. Foreign borrowing may also reduce the hazard of confiscation or expropriation since, if the subsidiary's properties are expropriated it may be in a position to stop payment on its obligations to creditors within the expropriating country.

The use of a foreign base company should generally not be undertaken unless it is anticipated that a substantial portion of the earnings of the company will be accumulated by it for reinvestment or other productive use abroad. The main tax advantage of base company operation exists only in respect of earnings which are not distributed as dividends, since dividends will be subject to the full impact of the United States income tax, with credits for foreign taxes attributable to the earnings out of which dividends have been paid.[64] However, to the extent that the foreign activities and investments of the enterprise are increasing, the reinvestment of the base company's earnings by it, in lieu of further investment by the parent, will, in effect, free an equivalent amount of the parent's funds for domestic purposes.

Theoretically, it is possible for the base company to make its earnings available to the parent by loans to it, but it is well to avoid such loans other than on a temporary basis, in view of the danger that they will be regarded as constructive dividends.[65] Where the parent company normally carries its foreign customers on open account or sells to its foreign customers on a deferred payment or installment payment basis, the burden of financing these customers can be taken over by the base company either by purchase of the accounts from the parent or by direct loans to the foreign customers. Such financing will automatically free for other purposes that portion of the parent's working capital which would otherwise be tied up in accounts or notes receivable.

In the case of a closely held corporation, it may be advisable for the shares of the base company to be held directly by the individual shareholders of the United States company in order that they may receive the dividends directly from the base company without dilution by the United States corporate tax on the foreign dividends. While the individuals will not receive the benefit of any credit for foreign taxes paid by the base company on earnings out of which the dividends have been declared[66] the only corporate tax to which

64. Int. Rev. Code of 1954, § 902.

65. The danger of such treatment is accentuated by the fact that a base company normally distributes no dividends.

66. The indirect credit of Int. Rev. Code of 1954, § 902, is available only to corporate shareholders.

the foreign earnings will have been subjected will be the foreign tax paid by the base company and its subsidiaries rather than the presumably higher United States corporate tax.

The earnings of a foreign base company can ultimately be returned to its United States shareholders, whether corporate or individual, only at the expense of payment of United States tax thereon.[67] Consequently, base company operation provides a deferral of United States tax and not a permanent exemption from that tax, except in the case of a base company which is owned directly by individuals and which is liquidated after the shares have passed through the shareholders' estates.[68] However, as a practical matter, base company operation may provide more or less permanent exemption from United States tax since, as in the case of purely domestic operations, it is unlikely that the entire amount of earnings would ever be paid out to shareholders until ultimate discontinuance of the business.

The earnings of a foreign base company may be returned to the United States shareholders as capital gain upon liquidation of the base company. In such event, neither the corporate nor individual shareholders will receive credit for foreign taxes paid by the subsidiary[69] but, instead, they will receive the benefit of the lower rate of tax on capital gain.

Whether or not it will be advantageous to return the entire accumulated earnings of the foreign subsidiary as ordinary dividends prior to liquidation, or partly as dividends and partly as a liquidating distribution, or entirely as a liquidating distribution, will depend upon the effective rate of foreign taxes paid on those earnings. Where the effective rate of the foreign taxes is 27%, calculation will show that the tax cost of liquidation is identical to the tax cost of dividend distribution; where the foreign tax rate is below 27% distribution on liquidation results in the lower tax cost and where the foreign rate is above 27% the distribution of ordinary dividends results in the lower tax cost. However, an accurate comparison of the relative advantages of each method of earnings distribution can be made only by calculating the credit allowable in respect of dividends paid out of the profits of each year during which the foreign base company was in operation. Since dividends are deemed to be distributed out of the most recently accumulated earnings[70] and the allowable credit is computed in respect of the earnings of each year from which the

67. INT. REV. CODE OF 1954, § 367 effectively prevents tax-free liquidation of a foreign subsidiary under § 332 except in exceptional circumstances.

68. INT. REV. CODE OF 1954, § 1014(a).

69. Freeport Sulphur Co. v. United States, 163 F. Supp. 648 (Ct. Cl. 1958). See Beauregard, *Distributions in Liquidation as Dividends in the Foreign Affiliate Tax Credit of the 1954 Code*, 41 VA. L. REV. 731 (1955) for argument that credit should be allowed.

70. See note 48 *supra*.

dividends are paid, in a particular case it may be found that a part of the earnings should be distributed as dividends and the balance distributed in liquidation. This is particularly true in the case of a base company which has obtained the benefit of foreign tax concessions, as it is likely those concessions will operate to produce the lowest effective tax during the early years of operation and the highest effective tax during the later years.

Where the shares of a base company are held by individuals, distribution of accumulated earnings in liquidation will always be preferable, since individuals are not entitled to any credit for foreign taxes paid by a corporation from which they have received dividends.

5. *Foreign Personal Holding Company Problems.*—A foreign base company which is either a subsidiary of a closely held United States corporation or owned directly by a small group of individuals, must be constantly on its guard against classification as a foreign personal holding company.[71] Foreign personal holding company status is almost inevitable if the base company meets the stock ownership requirement[72] and is primarily a holding company or acts primarily as the licensing representative for its United States parent.[73] Consequently, a foreign based holding company is generally not a suitable vehicle for the conduct of foreign operations where 50% or more of the shares are owned by not more than five individual United States citizens or residents. However, even under such circumstances some of the benefits of a foreign based holding company can be preserved by arranging for the base company to conduct directly a sufficient portion of the actual foreign operations as will produce gross operating income which is more than 40% of the total gross income of the corporation. Since gross dividend income from its subsidiaries will actually represent their net-after-tax income, a relatively small amount of direct operating income will be needed to counterbalance the subsidiaries' distribution of operating income as dividends. Furthermore, dividend payments to the base company can generally be controlled so that they will be made at such time and in such amounts as will not result in foreign personal holding company classification for the year.

Where a foreign base company is to conduct a part of its operations directly and a part through subsidiaries, and is confronted with the foreign personal holding company problem, thin incorporation of the subsidiaries may be undesirable; the automatic accrual of interest on the subsidiary's indebtedness would deprive the base company of the

71. INT. REV. CODE OF 1954, §§ 551-558.

72. INT. REV. CODE OF 1954, § 552(a)(2).

73. By INT. REV. CODE OF 1954, §§ 555(a) and 543(a)(1) royalties are personal holding company income.

necessary flexibility in the control of its foreign personal holding company income. Of course, direct conduct of all foreign operations by the base company through branches established in the countries of actual operations would generally eliminate the foreign personal holding company problem entirely.

Avoiding foreign personal holding company classification is particularly difficult where actual operations are to be carried on jointly with foreign investors. Generally, the foreign investors will require that their share of the profits be distributed to them with reasonable frequency. If the base company is to own part of the shares of the foreign operating company and the foreign investors the balance, the joint venturers may have conflicting interests, the one group desiring regular payment of dividends and the other desiring accumulation of the earnings in the operating company.

The following techniques will permit the American investors to obtain the benefits of a foreign base company without encountering foreign personal holding company problems, while permitting the foreign investors to withdraw their share of the earnings at regular intervals:

(a) A foreign base company may be organized by the American investors, its shares wholly owned by them. This corporation may enter into a partnership or joint venture with the foreign investors for the conduct of actual operations. If desired, the foreign investors may organize a separate corporation in the country of operation and the partnership or joint venture may be entered into with this corporation. Earnings of the venture will automatically belong to the parties in the agreed proportions and the base company's share of those earnings will constitute operating income and not foreign personal holding company income.[74] Withdrawal of profits by the foreign investors will not require that dividends be paid either to the base company or to its shareholders.

(b) A corporation may be formed in the country of operations with a part of its shares to be held by the base company (the shares of which are owned entirely by United States investors) and a part of its shares to be held by the foreign investors. The shares of the operating company may be of two distinct classes, either of which may be paid a dividend of its pro rata share of earnings without payment of an equivalent dividend to the other; if dividends are paid on one class without payment of dividends to the other, it would be required that a separate surplus reserve be established of an equivalent amount

74. Care must be taken, however, that the characteristics of the joint venture or partnership do not, as the result of the agreement or of applicable foreign law, result in treatment of the venture or partnership as an "association" taxable as a corporation. INT. REV. CODE OF 1954, § 7701(a)(3).

to be utilized solely for payment of dividends or other distributions to the other class of shareholders. In this manner, dividends could be paid to the foreign investors without payment of dividends to the base company.

(c) A base company, owned by the United States investors, may acquire direct ownership in a portion of the assets necessary to operate the venture, leasing those assets to an operating company owned entirely by the foreign investors, for a rental expressed as a percentage of the profits of the operating company. The remaining assets necessary for the venture would be acquired by the foreign-owned operating company and owned directly by it. Since the base company's sole income from the venture would be represented by rents, and since rents do not constitute foreign personal holding company income unless they amount to less than 50% of gross income,[75] foreign personal holding company status would be avoided. Should it be required that the base company make an additional investment in the operating company to provide a portion of the working capital, this investment may be made by way of loans, provided the interest, together with other personal holding company type income, does not exceed the rental income.

The above are merely illustrative of the methods available for solution of this rather difficult problem. The practical difficulties of working out a solution to the mutual satisfaction of the two groups of investors are great as they involve legal arrangements which are often regarded by foreign lawyers and businessmen as novel, peculiar and unnecessary.

B. Operating Subsidiary

As an alternative to carrying on activities in the foreign country by an operating subsidiary or branch of a base company, a foreign operating subsidiary may be owned directly by a United States corporation or by individual United States citizens or residents. Direct ownership of the foreign operating company by the United States taxpayer has the advantage of simplicity and is often the most suitable form where operations are to be carried on in but a single foreign country. Under such circumstances, there is, of course, no necessity for the homogenization of earnings from and taxes paid to several foreign jurisdictions, nor of providing a means whereby earnings may be shifted from one foreign operation to another without exposure to United States tax.

Where a directly owned operating subsidiary is used, the earnings

75. INT. REV. CODE OF 1954, § 543(a)(7).

of the subsidiary are, of course, insulated from United States taxation until distributed to shareholders. However, in order to obtain this insulation, it is necessary that the earnings be retained by the subsidiary, with consequent continuing exposure to whatever risks are present in the foreign jurisdiction. Therefore, this form of operation is generally suitable only where these risks are not considered to be serious, or where it is contemplated that a substantial portion of the foreign earnings will be returned through regular dividend distribution. Even where virtually all the foreign earnings are to be paid out currently as dividends, there may be an advantage in use of a foreign subsidiary, as compared with a foreign branch, to the extent that the foreign rate of tax approaches one-half the United States rate.[76] The foreign subsidiary will also provide insulation of the parent from the foreign jurisdiction and will establish closer identification with the foreign country.

From the point of view of taxation in the country of operations, it is generally a matter of indifference whether the shares of the operating subsidiary are held by a base company or directly by United States shareholders. Except where the foreign country has entered into a tax treaty[77] either with the United States or with the particular base country, the earnings of the operating company and the dividends paid by it will be taxed in the same manner in either case. There may, however, be a significant difference in the applicable exchange restrictions, and it may be found that investment and earnings may be withdrawn more readily by a base country parent than by a United States parent.

The methods of operation available to a directly-owned operating subsidiary are virtually as numerous as those for operating through a base company. Such a subsidiary can purchase the goods of the parent for resale, can sell the parent's goods on commission, or can operate under any of the other methods previously discussed. Likewise, the decision to withdraw earnings as dividends or as liquidating distributions involves the same considerations as have been discussed with respect to foreign base companies.

It will generally be desirable to use a foreign based company rather than a directly owned operating company, unless the foreign earnings are to be returned to the United States on a more or less current

76. As the amount of foreign tax is not distributable as a dividend that amount is subject only to the foreign income tax and not to the United States income tax. As a result, assuming 100% distribution, the combined foreign and domestic taxes will be as follows, where T represents the combined tax, U the United States effective rate and F the foreign effective rate: $T = U - F\,(U\text{-}F)$.

77. Twenty-two such treaties are in force. For collection of all international tax conventions see UNITED NATIONS DEPARTMENT OF ECONOMIC AND FISCAL AFFAIRS, FISCAL AND FINANCIAL BRANCH, INTERNATIONAL TAX AGREEMENTS, 8 volumes.

basis, or the foreign rate of tax is relatively high, or the accumulation of earnings within the country of operations is not objectionable.

V. WESTERN HEMISPHERE TRADE CORPORATION

Since a Western Hemisphere Trade Corporation must be a domestic corporation,[78] and since the sole benefit accorded such a corporation is, in effect, a reduction in the applicable United States tax rate,[79] this form of operation is feasible only where the non-tax factors do not require foreign incorporation and where the tax factors are such as to secure the benefits of the favorable United States rate. Obviously, where the law of the foreign country requires that the particular enterprise be carried on by a corporation organized under its laws, the use of a Western Hemisphere Trade Corporation is out of the question. Where the non-tax factors bearing upon the place of incorporation are neutral, determination of whether or not to use a Western Hemisphere Trade Corporation is largely a matter of arithmetic.

Where the effective foreign rate is lower than the effective United States rate applicable to a Western Hemisphere Trade Corporation, use of that form will result in taxation at the applicable United States rate on the Western Hemisphere Trade Corporation's earnings plus the intercorporate dividend rate on that portion of the remaining earnings which is distributed to the corporation's parent. If we assume that the applicable United States rate is the 38% maximum and that all earnings will be distributed as dividends, the total tax liability will amount to 38% plus 7.8%[80] of the remaining 62%, or 42.84%. If none of the earnings are distributed as dividends to the parent, but all earnings are accumulated for ultimate distribution in a tax-free liquidation of the Western Hemisphere Trade Corporation,[81] the tax burden will never amount to more than 38%. Actually, the burden may be somewhat less due to the exemption of the first $25,000 of taxable income from the corporate surtax.[82] For example, $100,000 of Western Hemisphere Trade Corporation income is taxed at an effective average rate of 32.5%.[83] Assuming that the foreign rate is below 32.5%, if all income is ac-

78. INT. REV. CODE OF 1954, § 921. A corporation organized in Canada or Mexico solely for the purpose of holding title to property in conformity with the laws of those countries will be treated as domestic. Rev. Rul. 55-372, 1955-1 CUM. BULL. 339.

79. INT. REV. CODE OF 1954, § 922. The rate reduction is achieved by a special deduction from gross income equal to that proportion of taxable income which 14 bears to the sum of the normal and surtax rates.

80. INT. REV. CODE OF 1954, § 342(a).

81. *Id.* § 332.

82. *Id.* § 11(c).

83. Taxable income = 100,000 − (14/52 × 100,000) = 73076.92. 30% × 73,076.92 + 52% (73,076.92 − 25,000.00) = 32,500.

cumulated until dissolution, the total tax burden will be 32.5%; if the entire income is distributed as a dividend to the parent, the combined Western Hemisphere rate and intercorporate dividend rate will be approximately 37.7%.[84]

Wherever the effective foreign rate is lower than the effective United States rate, the immediate tax burden will be confined to the foreign rate if a foreign corporation is used and no dividends are paid; if a Western Hemisphere Trade Corporation is used in such circumstances, the benefit of the lower foreign rate is abandoned. Where the foreign rate is higher than the Western Hemisphere rate, the maximum tax burden on a Western Hemisphere Corporation's earnings will be the sum of the foreign rate and the United States intercorporate dividend rate. Where the foreign rate is 48% or more, there will always be a disadvantage in the use of a Western Hemisphere Trade Corporation which pays dividends since it will not receive credit for the higher foreign tax and the parent will bear additional tax of at least 4.05% (7.8% of 52) on the intercorporate dividends, bringing the total tax burden to 52.05% or above.

In general, then, where dividends are low and the foreign tax rate is low, foreign incorporation is preferable since it permits deferral of the difference between the foreign and the domestic rate. Where the dividends are high and the foreign rate is high, either a branch or a foreign subsidiary is preferable in order to prevent the further burden of tax on intercorporate dividends. This leads to the general conclusion, which must be tested arithmetically in any given case, that a Western Hemisphere Trade Corporation affords a significant tax advantage only where a large portion of the earnings is to be distributed as dividends and the foreign tax rate does not exceed the level at which the intercorporate dividend rate will absorb the initial United States Western Hemisphere rate advantage.

A consolidated return of the Western Hemisphere Corporation and its parent will eliminate the intercorporate dividend tax, without imposition of the 2% additional consolidation tax on the Western Hemisphere Corporations earnings. If the group is already filing consolidated returns, consolidation will not generate any additional tax burden and will eliminate the intercorporate dividend tax. Prospective dividend policy will then be irrelevant to the decision, which will be governed largely by the relationship between the foreign and the Western Hemisphere rates of tax.

The Western Hemisphere Trade Corporation arithmetic is somewhat different in the case of natural resource extraction.[85] The percentage depletion allowance may reduce materially the effective rate

84. INT. REV. CODE OF 1954, § 1503(b).
85. See note 35 *supra*.

applicable to such a corporation and it may be desirable to use this form in order to preserve the benefits of allowable deductions for exploration and intangible expenses. Since dividends from a foreign corporation are taxable in full, subject to allowance of the foreign tax credit to corporate shareholders, the use of a foreign subsidiary for natural resource extraction results in forfeiture of these special deductions allowable under United States law.

Aside from the pure arithmetic, there are several other factors which bear materially upon the decision to use a Western Hemisphere Trade Corporation. Such a corporation is subject to the United States tax on accumulated earnings[86] and the collapsible corporation provisions are applicable to it.[87] It may be incorporated tax-free under section 351[88] and may be liquidated into its parent under section 332 without the necessity for a ruling under section 367. Its losses may be set off against consolidated income of an affiliated group which files consolidated returns[89] and, where there is no consolidation, it is entitled to the net operating loss carryback and carry-forward.[90]

Operation of a Western Hemisphere Trade Corporation raises many of the problems of operation as a foreign subsidiary since either form requires the transfer of business functions to a separate corporation and the handling of intercorporate transactions on an arm's length basis.[91] Where goods purchased from the parent are to be exported, either form requires that title to the goods be passed outside the United States to the foreign customer.[92] Under either form, sale of the parent's products on a commission basis will eliminate the title passage problem.[93] Except for the inability of a Western Hemisphere Trade Corporation to employ those methods of operation which produce non-business income such as rents or royalties, the methods available to one form are available to the other. A Western Hemisphere Trade Corporation, of course, cannot operate through subsidiaries of its own to any considerable extent due to the requirement that 90% of its gross income be from the active conduct of a trade or business.[94] It also must exercise greater care than a foreign subsidiary in avoiding United States source income since if more than 5% of its gross income is from a domestic source it will forfeit its preferred status, whereas a foreign subsidiary

86. INT. REV. CODE OF 1954, § 532(a).
87. *Id.* § 341.
88. INT. REV. CODE OF 1954, § 351 applies to transfers to any corporation other than a foreign corporation. INT. REV. CODE OF 1954, § 367.
89. INT. REV. CODE OF 1954, § 1503(b); Treas. Reg. § 1.502-3(a); Rev. Rul. 56-316, 1956-2 CUM. BULL. 597.
90. INT. REV. CODE OF 1954, § 172.
91. *Id.* § 482.
92. See note 13 *supra*.
93. See text accompanying note 63 *supra*.
94. INT. REV. CODE OF 1954, § 921(2).

which derives United States source income will, at worst, be required to pay United States tax only on that portion of its income.[95]

From the foregoing it will be apparent that the situations in which Western Hemisphere Trade Corporation operation is beneficial are limited indeed. The mechanics of creating and operating such a corporation are the same in most respects as are those for creating and operating a foreign subsidiary, with few of the advantages of the latter form except in the limited range of circumstances in which a moderate rate reduction may be achieved. It is for these reasons that the Western Hemisphere Trade Corporation form has not gained wide acceptance other than for pure export operations or for natural resource extraction.

VI. UNITED STATES POSSESSIONS CORPORATION

The principal advantage of a United States Possessions Corporation[96] stems from the fact that it is vested with certain of the tax aspects of a foreign corporation while retaining certain of the tax aspects of a domestic corporation. If such a corporation accumulates its foreign earnings it will obtain the benefit of whatever lower tax rates or exemptions from tax prevail in the source country, just as would a foreign corporation;[97] if the earnings are distributed as a dividend to a domestic parent they will be fully taxable, subject to credit for taxes of the possessions or foreign countries, just as would dividends from a foreign corporation;[98] if its earnings are distributed in liquidation to the United States parent, they will be received by the parent tax-free, without Treasury approval under section 367, just as would liquidating distributions of any other domestic corporation.[99] Thus, if all the income of a section 931 subsidiary is from sources outside the United States, there is no significant difference between a section 931 company and a foreign subsidiary other than the ease of incorporation and the automatic availability of the tax-free reorganization and liquidation provisions. If the income is distributed as a dividend, the combined tax burden is identical to that of a foreign corporation.[100] The tax treatment of a section 931 corporation which has no domestic income and which is owned directly by indi-

95. INT. REV. CODE OF 1954, § 882(b).
96. *Id.* § 931.
97. Such a corporation is taxable only in respect of income from sources in the United States and income from foreign sources received in the United States. INT. REV. CODE OF 1954, § 931(b).
98. INT. REV. CODE OF 1954, § 901(c)(1).
99. INT. REV. CODE OF 1954, § 367 applies only to "foreign corporations" as defined in INT. REV. CODE OF 1954, § 7701.
100. The dividends received deduction does not apply to a foreign corporation (INT. REV. CODE OF 1954, § 243(a)) or to a section 931 corporation (INT. REV. CODE OF 1954, § 256(a)(2)(B)). Corporate shareholders of either are entitled to foreign tax credit under section 902(a).

vidual citizens or residents of the United States is almost identical to that of a foreign corporation since its foreign and Possessions earnings are free of United States tax when earned, its dividends are fully taxable when distributed,[101] its accumulations of foreign income are free of the accumulated earnings tax,[102] and distributions in liquidation are taxable as capital gains.[103] The only advantage to individuals in the use of a section 931 corporation as compared with the use of a foreign corporation, is the relative ease of incorporation in the United States and the availability of the tax-free incorporation and reorganization provisions without approval under section 367.

In view of the fact that 80% of the gross income of a section 931 corporation must be derived from within the Possessions,[104] the method of operation must be such as will subject most of the income to taxes imposed by the Possessions. Thus, the advantage is limited to obtaining the benefit of any differential which may exist between the United States rate of tax and the Possessions rate of tax. However, this differential may be substantial since the rates prevailing in the Possessions are generally lower than the United States rates and, in the case of Puerto Rico (where this type of corporation is most commonly used), the industrial incentive concessions usually eliminate the Possessions tax entirely during the first ten years of operation.[105]

The methods available for operation of a section 931 company are similar to those available for operation of a foreign subsidiary. Where exportation from the United States is involved, title to the goods must pass within the Possession in order that the income will be from sources outside the United States and within the Possession. Where goods are manufactured in a Possession for sale in the United States or elsewhere, it is imperative that the method be such as will fix the source of the income as from within the Possession. Particular care must be exercised lest the section 931 company be deemed to have derived more than 20% of its gross income in the United States or a foreign country. If there is a lack of substance or arm's

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101. The individual shareholders would not be entitled to indirect credit for foreign taxes paid either by the section 931 corporation or the foreign corporation, but would be entitled to credit under section 901 for any Puerto Rican withholding tax on the dividends.

102. INT. REV. CODE OF 1954, § 531 imposes the tax on "accumulated taxable income"; taxable income of a section 931 corporation does not include foreign source income not received in the United States.

103. INT. REV. CODE OF 1954, § 331(c)(1). INT. REV. CODE OF 1954, § 341 appears to be inapplicable since ordinarily there is no "taxable income" to be derived from the property of a section 931 corporation.

104. INT. REV. CODE OF 1954, § 931(a)(1).

105. Puerto Rico Industrial Incentives Act of 1954, § 1(a), 13 L.P.R.A. § 241(a). See Friedman & Silbert, *Tax Advantages of Doing Business in Puerto Rico*, P-H TAX IDEAS, 8009; Rudick & Allen, *Tax Advantages of Doing Business Under the Puerto Rican Exemption Program*, 7 TAX L. REV. 403 (1952).

length dealing in transactions between the section 931 corporation and its parent or between it and foreign subsidiaries of its parent, income allocable to the United States or foreign sales may be attributed to the section 931 company and if that income is more than 20% of the gross income it will lose its exemption as to all of its income.

The principal difference between operation in the Possessions by a foreign corporation and by a section 931 corporation is that earnings which are accumulated by a section 931 corporation may be distributed to a corporate shareholder in a tax-free liquidation. Whether there will be a difference between taxation of the two forms by the Possessions will depend upon the tax laws applicable in the particular Possession. In the case of Puerto Rico, there will be no difference if all the earnings are from sources within Puerto Rico.[106] However, if a portion of the earnings is from outside Puerto Rico, that portion will be taxable by Puerto Rico to a Puerto Rican corporation but not to a section 931 corporation or a corporation organized in some third country.[107] Furthermore, Puerto Rico imposes a withholding tax of 30.45% on dividends by a domestic company or by any other company which derives more than 20% of its gross income from within Puerto Rico;[108] if more than 20% but less than 100% of the gross income is from within Puerto Rico, the tax applies only to the proportion of dividends which the Puerto Rican income bears to total income.[109] Consequently, where some of the income is to be derived from sources other than Puerto Rican, a reduction in the dividend withholding tax can be achieved by operating in Puerto Rico either through a section 931 company or through a branch of a company organized in a third country rather than through a Puerto Rican corporation.

A section 931 corporation which accumulates its earnings is preferable to a Western Hemisphere Trade Corporation whenever the effective rate of the taxes paid to the Possessions and to foreign countries is lower than the Western Hemisphere rate, since only the lower rate will be payable. If earnings are to be distributed, a Western Hemisphere Trade Corporation would be preferable, since it would bear the Western Hemisphere rate, at a maximum of 38%, and its dividend, after allowance of the intercorporate dividend deduction, would give rise to additional tax against the parent of approximately 4.8%, a maximum total burden of 42.8% as compared

106. The benefits of the Puerto Rican Industrial Incentives Act are available to both Puerto Rican and non-Puerto Rican corporations.

107. The Puerto Rican Income Tax Act of 1924, as amended, like the United States Internal Revenue Code, does not subject to tax the foreign income of foreign corporations.

108. Income Tax Act of 1924, § 19(f), 13 L.P.R.A. § 698(f).

109. *Ibid.*

with 52% which would be payable by a comparable section 931 company.[110] The result is different, however, where, as in the case of Puerto Rico, a withholding tax is imposed upon dividends paid out of earnings derived from the Possession. In that case, the combined tax burden will be the sum of the Western Hemisphere rate, the withholding tax on the remaining earnings, and the intercorporate dividend tax on those same earnings, less the tax reduction to the parent as the result of deductibility of the withholding tax. Many writers[111] have stated that the combined burden on earnings from Puerto Rico, which imposes a 30.45% withholding tax, may be approximately 57%.[112] However, this conclusion assumes that the withholding tax will be claimed as a credit so as to eliminate the tax on the intercorporate dividend; it does not take into account the fact that the withholding tax may be claimed as a deduction so as to reduce the tax on other income as well.[113] If the withholding tax is claimed as a deduction by the corporate shareholder, the result is as follows:

	Computation	*Taxes*
WHTC Net Income	100	
Tax	38	38.00
Dividend	62	
P.R. Withholding Tax (30.45%)		18.89
U.S. Tax on Dividend (7.8%)		4.84
		61.73
Deduction value of P.R. Withholding tax (52% x 18.89)		9.82
Net Combined Taxes		51.91

Thus, when all of the earnings are to be distributed, the tax burden will be almost the same whether a section 931 corporation or a Western Hemisphere Trade Corporation is used, and the choice will depend largely upon the extent to which activities are to be carried on outside Puerto Rico but in other areas of the Western Hemisphere. In

110. See note 76 *supra* for reduction in combined effective rate where the Possession's effective rate is lower than that of the United States.

111. Rudick & Allen, note 105 *supra;* Friedman & Silbert, note 105 *supra;* Crawford, *Foreign Tax Planning,* N.Y.U. 17TH INST. ON FED. TAX 385.

112. $38\% + (30.45\% \times 62\%) = 56.88\%$.

113. However, if the parent company derives income from other foreign sources it may be disadvantageous to claim a deduction for the Puerto Rican tax in view of the requirement that all foreign taxes must be treated alike, whether claimed as a deduction or as a credit. INT. REV. CODE OF 1954, § 164(b)(6).

the more realistic situation where less than all of the earnings are distributed currently, a section 931 corporation will produce the lower tax burden. For example, if the earnings are exempt under the Puerto Rican exemption program and 50% of the earnings are distributed, a section 931 corporation will pay no tax and its parent will pay tax of 52% on the distribution, resulting in an overall tax burden of 26% of the total Puerto Rican earnings; the Puerto Rican withholding tax would be absorbed by credit against the parent's tax. A Western Hemisphere corporation would pay a tax of 38% of the entire earnings and whether the parent deducted or credited the Puerto Rican dividend tax, that tax would increase the combined burden still further.

It may be advantageous to operate in a Possession such as Puerto Rico through a branch of a foreign base company, particularly where the Puerto Rican income is exempt from Puerto Rican tax. If the Puerto Rican gross income from the branch is supplemental to other base company income so that it is less than 20% of the total gross income of the base company, there will not be any withholding tax on dividends paid by the base company. Furthermore, earnings of the branch may be made available for other foreign operations without the dilution by United States tax, or by Puerto Rican withholding tax, to which a section 931 company or a Western Hemisphere Trade Corporation would be subject. It would not be desirable for the base company to operate in Puerto Rico through a subsidiary since it could not withdraw the Puerto Rican earnings without payment of the dividend withholding tax.

VII. Mixed Forms

In any particular situation it may be found that the form which is best suited to some aspects of the overseas activity is ill-suited to others, or that the form which is most appropriate for operation in some countries is inappropriate for operation in others. Similarly, a particular method of operation may be suitable for only a part of the overseas activities and another method or methods may be dictated by either the business or legal requirements relative to other aspects of the operation. It is thus theoretically possible that a given enterprise will utilize all of the different forms which we have discussed and all of the different methods. As a practical matter, such a proliferation of forms and methods is likely to result in an operating structure which is unmanageable, either because it is incomprehensible to management or because the structure is neither functional nor compatible with orderly conduct of the business operation.

Nevertheless, it will frequently be found that no single form or no single method will be universally suitable. An extractive industry, for example, may find it desirable to conduct its producing activities in South America through a Western Hemisphere Trade Corporation and to conduct its transportation, refining and marketing operations through a foreign operating subsidiary, a branch of a foreign base company, or a subsidiary of a foreign base company. Where foreign law requires that a particular enterprise be conducted in corporate form but the tax treatment of branches is more favorable, some of the advantages of branch operation may be salvaged by using a local corporation to carry on those phases of the operation which must be conducted by a local corporation and a branch of a foreign corporation for all others. Similarly, if local capital participation is required in order to conduct certain phases of the business, a domestic corporation may be organized to carry on those phases, with its shares to be owned jointly with the local investors, and a separate corporation or a branch of a third country corporation may be utilized to carry on the remaining phases of the activity. In some instances, a portion of the earnings from the country in which manufacturing operations are carried on may be siphoned off by means of royalties or technical service fees payable to the United States parent or to a sister company organized in a base country.

As previously noted, a base company may find it desirable to operate in some countries through branches and in others through subsidiaries, depending upon the tax laws prevailing in the respective areas. A company may be organized in Switzerland in order to obtain the benefit of the Swiss tax treaties with certain countries and a separate base company may be organized in the Bahamas, for example, in order to gain a foothold in the sterling area. It may even be desirable to have two separate base companies organized in the Bahamas, one of which will be a resident of the sterling area for currency control purposes and another of which will be a non-resident for such purposes in order that it may deal freely in non-sterling currencies.

The above, of course, are merely illustrative of the wide varieties of choice which are available, and of the adaptability of both form and method to the exigencies of the particular situation. The two most common errors in the structuring of international operations lie at opposite ends of the spectrum: on the one hand, there is sometimes a tendency to adhere doggedly to a unitary form of foreign operation in disregard of varying requirements for effective conduct of the business in different areas of the world; at the other extreme, is a tendency to attempt to over-refine and differentiate both form and method so as to meet precisely such varying requirements as

are found to exist. The practical ideal is somewhere between the two extremes of over-simplicity and over-complexity.

VIII. Conclusion

As was stated at the outset, it is not possible to provide a precise formula which will determine either the form or the method of operation in any given circumstance. The choices are numerous and the opportunities for creative imagination and ingenuity are great. We have been discussing primarily the relevance of United States law to the decision, but foreign law is equally pertinent. The planning of foreign operations is vastly more complex than the planning of domestic ones because the interaction of at least two tax and legal jurisdictions must be taken into account and because the selection of both form and method require evaluation of numerous alternatives. The variety of available alternatives is, in the abstract, somewhat staggering. But in a particular situation the field is generally narrowed to manageable proportions. The greatest danger lies perhaps in excessive ingenuity. The touchstones of sound planning and an easy conscience are a profound respect for the cold realities of section 482 and the comforting reinforcement that substance gives to form.