A Practical Guide to Advising Clients Entering into Foreign Joint Ventures in the Face of Changing Tax Laws

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A PRACTICAL GUIDE TO ADVISING CLIENTS ENTERING INTO FOREIGN JOINT VENTURES IN THE FACE OF CHANGING TAX LAWS

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I. INTRODUCTION AND OVERALL CONSIDERATIONS

A. General

1. Businesses of all sizes have the opportunity to access foreign markets never before available. New markets may be penetrated by selling to local distributors, selling directly to customers, licensing third parties, establishing wholly owned subsidiaries, or forming joint ventures with local partners. For example, a U.S. construction firm may become the general contractor on construction projects in China; a software development firm may be engaged to develop custom software programs for European manufacturing companies; and a chemical company may license its technology to foreign investors establishing an agricultural chemicals manufacturing plant in India.

2. Joint ventures have become a favored approach to entering foreign markets because they allow the U.S. investor to pool skills and share risks. For example, the U.S. investor may provide technology, capital, management skills and training, and the foreign partner may provide local knowledge, access to markets, personnel and capital.

3. This presentation discusses selected topics that relate to advising U.S. persons entering into foreign joint ventures, noting aspects of the Revenue Reconciliation Act of 1993 that apply to the discussion and summarizing other foreign-related provisions of the new tax law.

B. Tax Planning Issues

1. Evaluating the type and amount of applicable foreign taxes.

2. Planning to maximize U.S. foreign tax credits to achieve the lowest overall tax burden.

3. Selecting and characterizing the joint venture entity.
4. Planning for transfers of technology and other property to the joint venture.

5. Planning for the presence of U.S. personnel in the foreign country.

6. Determining whether Section 482 or foreign transfer pricing tax laws apply to regulate transfer pricing between the joint venture and its owners.

II. GENERAL FOREIGN AND U.S. TAX CONSIDERATIONS

A. Foreign Tax Aspects

1. Local counsel will be required to provide host country tax advice.

2. Applicable foreign taxes will include income and withholding taxes; retail sales, value added, and other turnover taxes; real property taxes; and excise taxes and customs duties.

3. Many jurisdictions offer tax incentives such as tax holidays and reduced tax rates to encourage investments. For example, China grants a tax holiday for two years and a 50% tax rate reduction to foreign investments in manufacturing, production, and technologically-oriented enterprises. It also refunds corporate income taxes paid with respect to certain reinvested profits.

4. Watch for multiple applications of transfer taxes where more than one related entity is involved in the production and distribution process. For example, some jurisdictions impose a turnover tax each time a sale is made with no exemption for wholesale transactions, sales to related parties, or prior taxes paid. In such jurisdictions, the use of a separate entity to distribute systems of components manufactured by a related joint venture and bought from third parties may place the operation at a pricing disadvantage vis-a-vis competitors.

5. Consider whether it is possible to eliminate expenses from the excise tax or customs duty base.

6. It is important for your U.S. clients to avoid acquiring a taxable presence in the foreign country under its internal tax laws and applicable income tax treaty provisions.

   a. Foreign countries typically assert tax based on the presence of assets or personnel, or the conduct of business, in the country. A careful U.S. investor will avoid maintaining bank accounts in,
leasing property in, or sending personnel other than temporary business travelers to, the foreign country.

b. Income tax treaties normally permit local personnel to perform preparatory and auxiliary or liaison-type activities that do not constitute a taxable presence. See, e.g., West Germany/United States Income Tax Treaty Article 5(4)(d), (e).

c. Conduct all local activities through the local entity or a separate services provider that may be subjected to foreign country taxation.

B. U.S. Foreign Tax Credits and Reduction of the Overall Tax Burden

1. U.S. persons pay U.S. income tax on their worldwide income at rates ranging up to 35% for corporations and 39.6% for individuals. To avoid double taxation (by the foreign country and by the United States), U.S. persons may claim a foreign tax credit for foreign taxes paid with respect to foreign source income. The credit offsets U.S. income tax liability on a dollar-for-dollar basis. See Sections 27(a) and 901 et seq. of the Internal Revenue Code (the "Code").

a. Foreign income taxes, including foreign corporate income taxes paid by a foreign subsidiary with respect to amounts distributed as dividends or deemed distributed under Subpart F, and withholding taxes on dividend, rent, royalty and interest payments, are creditable taxes. Sections 901, 902, 903, 960; Reg. Sections 1.901-2, 1.902-1, 1.903-1.

b. Income tax treaties provide additional rules and benefits and attempt to resolve any unusual aspects of meshing the two jurisdictions’ tax laws. See, e.g., United Kingdom/United States Income Tax Treaty Articles 10 and 23 (dealing with the effect of the U.K. imputation corporate tax system on U.S. investors).

2. The Code contains a two-component limitation on a taxpayer’s ability to credit foreign taxes.

a. First, under the rate-based component of the limitation, a U.S. taxpayer is precluded from crediting more foreign taxes than the U.S. tax otherwise due. Section 904(a).

(1) Foreign tax credit planning requires maximizing foreign source income and minimizing U.S-incurred deductions that are treated as foreign source by the source of income and deduction rules of Sections 861-865 and including particularly the interest expense allocation rules of Regulation Sections 1.861-8 through -13. It is disadvantageous to have deductions
allocated and apportioned to foreign sources if they are not actually deductible against foreign source income, which may be the case for U.S.-incurred interest expense, U.S.-based research and development costs, and state taxes.

(2) The practical effect of the rate-based limitation is that tax is paid at the higher of the U.S. or foreign effective tax rates, as follows:

(a) So long as the effective foreign tax rate is less than the effective U.S. tax rate, the United States will always "top up" the tax to the U.S. tax and collect an incremental or "residual U.S. tax" equal to the difference between the U.S. tax and the foreign tax. In other words, tax in an amount equal to the U.S. tax is paid - part to the foreign jurisdiction and the rest to the United States.

(b) If the effective foreign tax rate exceeds the effective U.S. tax, no additional U.S. tax is due and the investment bears the high foreign tax burden. Foreign taxes in excess of the U.S. tax may be carried back two years and forward five years, Section 904(c), and used to offset the residual U.S. tax on low-taxed foreign source income that is in the same category (see below).

b. Second, under the separate basket component of the limitation, the rate-based limitation is applied to different categories or "baskets" of income. Section 904(d). The effect of basketing is to permit the averaging of foreign tax rates only with respect to the same types of foreign source income.

(1) The relevant baskets for typical foreign joint ventures are the general basket, which includes foreign operating income and dividends from all more than 50% owned subsidiaries, and the separate baskets for dividends from each 10-50% owned subsidiary. Section 904(d)(1)(E), (I). There are also baskets for passive income, financial services income, shipping income, and certain interest subject to high withholding taxes. See generally Section 904(d)(1).

(2) When a U.S. taxpayer has both low-taxed and high-taxed foreign source income, foreign tax planning involves ensuring to the extent possible that the income is in the same basket to permit the use of the excess foreign taxes to shelter the low-taxed foreign source income.
3. From a U.S. foreign tax credit standpoint, your client normally will be better off owning a majority of the vote or value of foreign joint ventures conducted in corporate form because of the potential to mix low-taxed and high-taxed incomes, as follows:

a. Dividends from each 50% or less owned foreign subsidiary are in a separate basket and that investment is taxed at the higher of the U.S. or the foreign tax rate with no opportunity for averaging of foreign tax rates;

b. Dividends from more than 50% owned foreign subsidiaries normally are general basket income that is mixed with other operating income and dividends from majority owned foreign subsidiaries, permitting the averaging of foreign tax rates to use excess foreign taxes as shelter from the residual U.S. tax on low-taxed income; and

c. Interest and royalties from a 50% or less owned subsidiary generally are passive income taxed at the higher of the U.S. or foreign tax rate whereas the same items received from a majority owned joint venture are general basket income (assuming that essentially all of the venture's income is business income). See Section 904(d)(3) (under lookthrough rules, dividends, Subpart F inclusions, interest, rents, and royalties from controlled foreign corporations are characterized for foreign tax credit limitation purposes by reference to the income of the payor). See also Reg. Section 1.904-5(h) (a similar rule applies to certain payments from related partnerships).

To illustrate: Assume that your client's Foreign Country X joint venture ("JV") and Foreign Country Y subsidiary ("Sub") each earns $100 of taxable income, that JV pays Foreign Country X tax of $7.50 (the maximum rate through the first five years of profitability based on the grant of tax incentives) and Sub is taxed at a rate of 50% for a tax of $50, and that each pays a dividend of its entire after-tax earnings. The U.S. tentative tax on each $100 of income is $35 (assuming a 35% tax rate). If each item of dividend income is in a separate foreign tax credit basket because the U.S. taxpayer owns 50% or less of each of the corporations, the U.S. taxpayer pays a $27.50 residual U.S. tax on the income from JV in addition to the $7.50 already paid to Foreign Country X, for a total of $35, and no more with respect to the dividend from Sub, for a total of $85 of tax with respect to the $200 of income. In contrast, if the U.S. taxpayer owns more than 50% of each of the entities, the dividends...
are in the general basket and mixed together for purposes of computing the foreign tax credit limitation. In this case, the U.S. taxpayer has paid $57.50 of foreign tax, and the tentative U.S. tax is $70 (35% of $200), so the U.S. taxpayer pays the IRS $12.50 of U.S. income tax. The $14 of excess credits on the income from the high-taxed Sub (this is money the U.S. taxpayer has already paid out) shelters the low-taxed income from JV from a large portion of the residual U.S. tax, so the total tax liability would be $70 on the same $200 of income.

Economically, this means that the rate of return on an investment in a 50% or less owned JV will always be based on the greater of the U.S. tax or the foreign tax because the United States will always collect the residual U.S. tax. In contrast, the rate of return on an investment in a more than 50% owned JV may be based on less than the full U.S. rate because excess foreign tax credits from other subsidiaries may shelter the low-taxed income from the residual U.S. tax. To what extent the U.S. taxpayer actually enjoys the benefits of tax rate averaging depends on its worldwide foreign tax credit position when it receives the income, which varies constantly depending on many variables (e.g., relative profitability in high tax and low tax jurisdictions, relative accounting adjustments to conform to U.S. tax principles, and relative U.S. and foreign tax rates).

4. When actual majority ownership of a joint venture conducted in foreign corporate form is not attainable under the circumstances (e.g., because the foreign partner requires 50% or more ownership, the laws of the foreign jurisdiction restrict the amount of non-local ownership, or less than a majority ownership interest is desired for business reasons), the U.S. taxpayer may obtain the favorable foreign tax credit treatment by meeting indirect or constructive ownership requirements of the Code without actually owning more than 50% of the joint venture’s primary equity interests or by having the joint venture treated as a partnership for U.S. tax purposes.

a. Technical majority ownership may be obtained by one of the following devices. Where possible, it may be prudent to engage in commercially meaningful transactions such as buying a round lot of shares when acquiring publicly traded stock.

(1) Owning an equity interest in the joint venture partner, which gives the U.S. person indirect ownership in the joint venture. Section 958(a)(2). Whether this is practical under the circumstances may depend on whether the joint venture partner has publicly traded equity interests and/or will permit the U.S. investor to own part of it.

(2) Owning sufficient nonvoting preferred stock in the joint venture to give the U.S. investor more than 50% of the value
of the joint venture. Section 951(b). The usefulness of this approach depends on whether the foreign country’s joint venture laws provide for multiple classes of ownership interests. It may be possible to give the joint venture partner debt yielding roughly the same amount as the dividends on the preferred stock to counterbalance the U.S. investor’s share of profits, although such an approach runs obvious risks of challenge by the Internal Revenue Service based on the character of the debt as equity.

(3) Owning options to acquire additional interests in the joint venture, because the underlying equity interest is treated as constructively owned by the U.S. investor. Section 958(b). Options are useful only if the foreign country’s laws recognize options and you can explain such instruments to the joint venture partner.

(4) Having the U.S. and foreign investors own the joint venture entity through a U.S. corporation or partnership that owns 51-100% of the joint venture entity, which qualifies the joint venture for the desired foreign tax credit treatment (as a controlled foreign corporation) notwithstanding the fact the U.S. shareholders own 50% or less of the interests in the U.S. entity.

b. Alternatively, it may be possible to structure the joint venture so that it is treated as a partnership for U.S. tax purposes.

(1) Partnership status achieves the desired foreign tax credit treatment because the partnership’s income is categorized as general basket income (assuming the partnership is earning active business income) regardless of the U.S. taxpayer’s percentage ownership interest.

(2) However, in the partnership format, the U.S. taxpayer incurs U.S. tax on its share of the entity’s income each year regardless of whether distributions are made unless the interest is held through a foreign holding company located in the same jurisdiction. Sections 701 et seq.

(3) As discussed below in Part III.B.2. and 3., partnership treatment requires that the venture entity be established with certain characteristics that can have significant business consequences.

5. **Absent majority ownership or partnership status, your clients will not be able to avail themselves of the full economic value of tax incentives.**
C. **Effect of New Tax Laws**

1. The new tax law raises the corporate income tax rate to 35% and the individual tax rates to as much as 39.6%, which will generally reduce the U.S. person's return on investment and make it less likely that the taxpayer will have excess foreign tax credits to shelter low-taxed foreign source income from residual U.S. tax. The imposition of residual U.S. tax in effect largely eliminates the advantages of foreign tax incentives and simply transfers tax dollars from the foreign jurisdiction granting tax incentives to the U.S. Treasury.

III. **CHOICE OF ENTITY**

A. **General Tax Stakes**

1. The U.S. taxation of profits earned by the joint venture depends on whether the entity is taxable as a partnership or as a corporation.

2. In the case of an entity taxable as a corporation, the general rule is that U.S. tax is not imposed until the profits are repatriated (e.g., as dividends, interest, royalties, management fees, or gain from disposition of an equity interest).

   a. There are major exceptions to tax deferral for tax-haven type income under the controlled foreign corporation provisions of Subpart F of the Code, the passive foreign investment company rules, and the foreign personal holding company provisions. See Sections 951 et seq.; 1291 et seq.; 551 et seq.

   b. The deferral of U.S. tax is critical to taking advantage of low foreign tax rates. If U.S. tax is not imposed currently, there is a greater amount available for reinvestment in low-tax jurisdictions, whereas current U.S. taxation results in the imposition of the residual U.S. tax and effectively means the investment bears the full U.S. tax burden except to the extent sheltered by excess foreign tax credits. See supra at Part II.B.

3. In the case of an entity taxable as a partnership, profits are subject to current U.S. taxation regardless of whether the entity distributes them. Sections 701 et seq.

   a. Partnership treatment may be critical to having profits treated as general basket income for foreign tax credit purposes and blending foreign tax rates when majority ownership of the joint venture is not possible. See supra at Part II.B.3.
b. Partnership treatment is also desirable if the U.S. investor is an individual, an S corporation, or a partnership with individual partners because such persons do not qualify for the indirect foreign tax credit provided by Section 902 and double taxation would result from operating through a foreign corporation. See generally Bell and Shoemaker, *S Corps Can Make Maximum Use of Tax Treaties, Foreign Tax Credits*, 1 J. Int'l Tax'N 197 (1990); Ortolani, *U.S. Tax Implications of International S Corporation Activities*, 3 J. S Corp. Tax'N 206 (1992); Zink and Mezzo, *Subchapter S Corporations in the International Business Arena*, 20 Tax Advisor 105 (1989).

c. Note that a partnership may be treated as a separate unit whose losses may not offset income of other members of a consolidated return group for U.S. tax purposes. See Section 1503(d).

B. Characterizing the Entity: Distinguishing Partnerships from Corporations

1. Regardless of whether the applicable foreign law characterizes the joint venture entity as a corporation or a partnership, the U.S. tax treatment depends on the entity's classification for U.S. tax purposes. Classification is commonly an issue in the case of a foreign limited liability company that the U.S. investor seeks to have classified as a partnership for U.S. tax purposes (the entity remains a limited liability company for all other purposes).

2. The determination of whether an entity is taxable as a corporation or a partnership turns on the presence or absence of the following four corporate characteristics. The entity is classified as a partnership if it lacks two of them. See Section 7701; Reg. Section 301.7701-1(c), -2; Rev. Rul. 88-8, 1988-1 C.B. 403. See also McKee, Nelson and Whitmire, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* para. 3.06-3.08 (2d ed. 1990); 1 Int. Rev. Man. Audit (CCH) at Exhibit 500-4.

a. Continuity of life. An entity does not have continuity of life if it automatically dissolves on the happening of a specified event such as bankruptcy or insolvency of any of the interest holders without further action. See Reg. Section 301.7701-2(b)(1); PLR 9121025. See also Reg. Section 301.7701-2(b)(3), -2(e)(1).

b. Free transferability of interests. Interests are not freely transferable if they may not be transferred without the permission of the other owners, which permission may be withheld for any reason or for no reason. See Reg. Section 301.7701-2(b), -2(e); Rev. Proc. 92-33, 1992-1 C.B. 782; PLR 9001018.
c. Centralized management. An entity has centralized management if any person or group that does not include all of the interestholders has the exclusive authority to make all management decisions. See Reg. Section 301.7701-2(c), -2(g) Ex. 7, -3(b)(2). See also Rev. Rul. 93-6, 1993-1 C.B. __, Rev. Rul. 88-79, 1988-2 C.B. 361, Rev. Rul. 88-76, 1988-2 C.B. 360 (centralized management in the case of domestic limited liability companies). The foreign joint venture law may not permit joint ventures without centralized management, or it may be impractical to operate a joint venture without it.

d. Limited liability. An entity has limited liability if no owner is personally liable for the debts of the entity beyond its equity investment. See Reg. Section 301.7701-2(d). Foreign corporate and limited liability company laws by definition provide the corporate characteristic of limited liability. If limited liability is not mandated by law, U.S. investors may wish to use a special purpose subsidiary to hold the joint venture interest yet insulate their assets from liability. The subsidiary must have substance (e.g., substantial assets other than the joint venture interest) to be respected. See Rev. Proc. 89-12, 1989-1 C.B. 798, Rev. Proc. 92-88, 1992-2 C.B. 496; GCM 39789.

3. The determination regarding whether the entity lacks any of the above characteristics is based on the rights and obligations created under local law, and thus the tax planner is required to devise a plan to attain the desired characterization and then consult with foreign counsel regarding the effectiveness of the applicable provisions under local law. See Reg. Section 301.7701-1(c); Rev. Rul. 93-4, 1993-1 C.B. __; Rev. Rul. 73-254, 1973-1 C.B. 613. See also U.S. Internal Revenue Service Reconsidering Classification of U.S. Limited Liability Companies, TAX NOTES INT'L. 566 (August 30, 1993); PLRs 9216004, 9210039, 9001018, 9131057, 9122074.

4. Altering the characteristics of an entity to attain partnership status is likely to have significant business consequences. For example, providing for automatic dissolution on the bankruptcy or insolvency of an owner subjects the U.S. investor to the financial integrity of its partner. Likewise, giving the foreign partner the right to restrict the U.S. investor’s right to transfer its joint venture interest may greatly decrease the value of the interest.
IV. TRANSFERS OF TECHNOLOGY AND OTHER PROPERTY

A. Contributions of Technology

1. Your client may wish to contribute technology in exchange for a joint venture entity interest to conserve cash, and foreign partners may expect such contributions.

2. The contribution of technology in exchange for a joint venture interest has adverse U.S. tax consequences because the U.S. transferor is required to pay U.S. tax on a "deemed royalty" resulting from the transfer (i.e., it has taxable income over the period the joint venture uses the technology even though it receives no cash to pay the tax). Moreover, it is possible for the Internal Revenue Service to adjust retroactively the amount of the deemed royalty to reflect the actual profitability that results from the joint venture's use of the contributed technology, producing more taxable income from a contribution than appeared likely when the venture is formed if it becomes particularly profitable from the use of the contributed technology. Section 367(d); Reg. Section 1.367(d)-1T.

   a. The adverse treatment occurs notwithstanding the fact that the transaction is described in Section 351 (or Section 721), which normally provide tax free treatment to such transfers. Section 367(a)(3)(B)(iv), (d)(1).

   b. The deemed royalty is treated as U.S. source ordinary income so there is no opportunity to offset the U.S. tax due with foreign tax credits, including taxes paid by the joint venture. Section 367(d)(2)(C); Reg. Section 1.367(d)-1T(c)(3). The transferor's tax basis in its joint venture interest is increased by deemed amounts taken into income and the deemed royalty reduces the venture's earnings and profits for purposes of computing the U.S. foreign tax credit. Section 367(d)(2)(B); Reg. Section 1.367(d)-1T(c), (g).

   c. Certain contributions involving the transfer of an operating intangible, a transfer compelled by the host foreign country, or a transfer occurring within three months of organization of the foreign corporation (if the U.S. transferor is a 40-60% owner and intangible property comprises at least 50% of the property transferred) may be treated as sales. See Reg. Section 1.367(d)-1(g)(2). A sale involves up-front tax costs because the gain is taxable currently, although it limits the amount taken into income by avoiding the commensurate with the income standard unless the transferor and the joint venture are under common control within the meaning of Section 482.

   d. For these purposes, technology is defined broadly to include virtually all intangible assets such as patents, copyrights, trademarks and
tradenames, processes, designs, patterns, methods, programs, systems, procedures, long-term purchase and supply contracts, surveys, studies, technical data, customer lists, and similar items that have substantial value independent of the services of an individual. It does not include items that are more in the nature of services such as business management practices; generic business information based on skill and experience; the knowledge required to operate a piece of machinery; advice regarding plant construction or the layout of plant machinery and equipment; and the training of employees that is essentially educational in nature. Sections 367(a)(3)(B)(iv), 936(h)(3)(B); Reg. Sections 1.367(a)-1T(d)(5)(i), 1.367(d)-1T(b).

e. Transfers to foreign joint ventures that are characterized as partnerships for U.S. tax purposes normally incur the same results as transfers to joint venture corporations. Although Section 1491 imposes a 35% excise tax on transfers of appreciated property to a foreign partnership, the transferor may instead elect to have the transfer treated under Section 367 principles or as a recognition transaction under Section 1057. The elections normally are made because they result in a basis step-up and thus are more advantageous than being subjected to the excise tax. See Sections 1491-94 and the regulations thereunder.

3. If it is necessary to contribute some technology, the adverse tax results and potential exposure may be limited by contributing only older technology without unusual profit potential or a long useful life. In practice, this may not prove to be a limitation because many jurisdictions restrict the amount of technology that may be contributed to a specified percentage of the equity investment.

a. To substantiate the deemed royalty reported on the U.S. income tax return, the contribution of technology should be backed up with contemporaneously developed documentation that shows the value assigned to the contributed technology, the amount of the deemed royalty, and the anticipated useful life of the technology. See new Section 6662(e), requiring contemporaneous documentation to avoid transfer pricing penalties if Section 482 applies.

4. Contributions should be of exclusive rights to the technology in the geographic area for its remaining life to avoid potential issues relating to whether there has been a transfer of property. See Fleming, Domestic Section 351 Transfers of Intellectual Property: The Law as It Is vs. The Law as the Commissioner Would Prefer It to Be, 16 J. CORP. TAX. 99 (1989); E.I. du Pont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct.Cl. 1973).
5. A purported license or sale to avoid Section 367(d) may be disregarded if the terms of the transaction differ greatly from the economic substance of the arrangement or terms that unrelated parties would accept. See Reg. Section 1.367(d)-1T(g)(4)(ii).

B. Licensing Technology

1. The most tax-efficient method of transferring technology involves licensing it to the joint venture because the resulting royalty is foreign source income that typically is in the general basket for foreign tax credit purposes (assuming that the licensor owns a majority of the licensee joint venture, that the licensor created the intangible and/or has sufficient licensing activity to qualify the royalty for active business treatment, or that the royalty is high taxed passive income). See Sections 904(d)(2)(A)(i), (iii); 904(d)(2)(F); 904(d)(3)(C); Reg. Sections 1.904-4(b)(2), -5(c), 1.954-2T(b)(5), (d).

a. However, the royalty effectively diverts profits to the licensor and thus may require a makeup payment to the joint venture partner to maintain the negotiated profit split based on joint venture interests (e.g., a payment for services).

b. It also moves profits to the United States, which effectively negates any local tax incentives the joint venture enjoys if the U.S. is a higher tax jurisdiction.

2. Terms of the license.

a. The license should provide for a royalty that is contingent on productivity.

b. The license should transfer nonexclusive rights to the technology.

(1) The transfer of exclusive rights, even in a limited geographic area, is treated as a sale for tax purposes. See Petry, Taxation of Intellectual Property (1989); Cross, Taxation of Intellectual Property in International Transactions, 8 VA. TAX REV. 553 (1989); Masek, Planning for Outbound Transfers of Intangible Property, TAX NOTES INTERNATIONAL 915 (September 1990).

c. The royalty rate must be set by reference to an objective analysis of royalties in comparable transactions involving unrelated parties (preferably involving your client and a third party; if no comparable transactions involving the U.S. transferor are available, use a transaction involving two third parties). Adjustments must be made to
take into account different circumstances (e.g., differences in the nature of the markets or terms of licenses).

(1) Section 482 and the commensurate with the income standard will apply if the U.S. transferor controls the joint venture. See B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), cert. den., 407 U.S. 934 (1972).

(2) Even if Section 482 is not applicable, it provides a framework for the economic analysis in deriving an appropriate royalty rate.

(3) If the royalty rate is set too low, the Internal Revenue Service will ignore the license as a sham and apply Section 367(d) to the transfer. Likewise, the grant of a royalty-free license is likely to be treated as a contribution to the joint venture subject to Section 367(d). Reg. Section 1.367(d)-1T(g)(4)(ii).

d. To help deal with joint venture cash flow problems, royalties may be graduated so that they are greater in magnitude in the later years as the venture becomes established (e.g., five percent of sales in the first four years and ten percent of sales thereafter).

3. In some circumstances, it may be advantageous to sell technology instead of licensing it because a sale results in income equal to the sale price less the basis in the intangible and the income may be capital gain subject to a lower tax rate.

a. If the payment is contingent on productivity, a sale gives the same tax results as a license - foreign source income that is in the general limitation basket. See Sections 865(a), (d)(1), 904(d)(2)(A)(i), 954(c)(1)(B)(i), 954(c)(2)(A). See also Henry Vogt Machine Company v. Commissioner, T.C. Memo 1993-371.

b. If the sale if for a fixed price, the results differ because the transferor generally has U.S. source income. See Section 865.

(1) The income may be capital gain subject to a lower tax rate. Consider Section 1249(a) (ordinary income treatment if seller controls transferee); Heyde, Transfers of Technology: Appropriateness of Capital Gain Treatment, 64 TAXES 3 (1986).

(2) The amount of taxable income resulting from the fixed price sale is limited to fair market value less tax basis in the intangible as of the date the transfer occurs unless Section 482 applies, in which case the transfer is subject to the commensurate with the income standard.
Because such income is U.S. source, foreign tax credits would not be available for withholding taxes and thus double taxation would result if the foreign country imposes withholding tax, perhaps negating the value of capital gain treatment.

Installment payments would involve treatment of a portion of the payments as interest. See Reg. Section 15A.453-1.

c. Sale treatment is triggered by transferring exclusive rights in the property in geographic region such as a country. See, e.g., Petry, Taxation of Intellectual Property (Matthew Bender 1989); Cross, Taxation of Intellectual Property in International Transactions, 8 VA. TAX REV. 553 (1989); Masek, Planning for Outbound Transfers of Intangible Property, TAX NOTES INTERNATIONAL 915 (September 1990).

C. Contributions of Machinery and Equipment

1. There is normally no U.S. tax cost associated with the contribution of machinery and equipment and other assets that will be used in the venture's trade or business in exchange for a joint venture interest. Section 367(a)(3); Reg. Section 1.367(a)-2T. However, the transfer of used machinery and equipment is subject to U.S. tax to the extent the transfer price exceeds tax book value. Reg. Section 1.367(a)-4T(b) (limited to the amount of depreciation deductions taken on the property).

2. Transfers to ventures that are characterized as partnerships for U.S. tax purposes are subject to the 35% excise tax provided in Sections 1491-1494 unless the transferor elects to have Section 367 principles apply or to recognize gain under Section 1057.

D. Effect of New Tax Laws

1. The reduction in the amount of R&D cost allocated to U.S. sources for foreign tax credit purposes will provide an incentive to perform R&D work offshore to obtain foreign tax deductions.

2. New Section 6662(e) statutorily requires increased documentation to avoid transfer pricing penalties under Section 482.

V. FOREIGN SERVICE EMPLOYEES AND OTHER PERSONNEL

A. Potential for Creating Taxable Presence

1. Your clients must be cautioned to avoid acquiring a taxable presence when providing services in the host country, which would subject the
client to host country internal corporate income tax on income attributable to the presence and require the filing of tax returns. The tax base could range from a deemed profit (e.g., 10% of cost) to a portion of the U.S. person's worldwide sales.

a. Under tax treaties, a taxable presence is created only if the U.S. person has a permanent establishment in the country.

b. In the absence of a treaty, the country's internal tax laws determine whether a taxable presence exists.

2. The U.S. investor may create a taxable presence by establishing an office or other fixed place of business in the host country, or by furnishing services in the country.

a. Most treaties have exceptions to the creation of a permanent establishment for liaison and preparatory and auxiliary-type activities. See, e.g., West Germany/United States Income Tax Treaty Article 5(4)(d), (e). Issues sometimes arise regarding whether the activities fit within the scope of the exception.

b. Many treaties with developing nations permit the host country to impose tax on U.S. persons rendering services in the country for a certain number of days ranging from 90 days to 180 days in a 12 month period. See, e.g., China/United States Income Tax Treaty Article 5(3)(c) (the performance of services, including consultancy services, for six months in any twelve month period for the same or a connected project).

(1) Such provisions present practical problems in furnishing temporary technical or management services to the joint venture without acquiring a taxable presence. The better view is that furnishing such services, particularly if they are furnished at cost, should not produce a taxable presence, but it would be risky to assume there is no taxable presence without obtaining an advance ruling from the host country's tax authorities.

c. Avoiding problematic levels of activity requires that the U.S. person render services in the United States or, after the startup phase, by an employee assigned temporarily to the joint venture or to a separate services provider, which will be cumbersome in the case of short-term visitors. Written guidelines should be developed (e.g., dealing with the use of company credit cards and local payroll functions) and activities monitored. It may be possible to obtain a tax ruling from the host country tax authorities that certain limited activities will not create a taxable presence.
B. **Contributions of Services for Equity**

1. The contribution of services in exchange for a joint venture interest will require the payment of U.S. tax on the value of the interest in the year of receipt. As the U.S. transferor will deduct the cost of the services when they are performed (offsetting the income except to the extent of Ford's profit, if any), this is a timing and cash flow disparity matter.

C. **Pre-Joint Venture Engineering Activities**

1. To meet production deadlines, the U.S. investor may need to commence engineering services relating to future joint venture operations before the joint venture is formed.
   a. The services may be performed pursuant to contracts requiring the joint venture partner to bear the costs until the joint venture is formed, at which time the joint venture will assume responsibility and reimburse the partner for payments it has made.
   b. Engineering services contracts should provide that the U.S. client is receiving payment solely for the rendition of services in the United States.
   c. Any technology (such as knowhow or secret processes, including technology related to the engineering services) should be transferred separately pursuant to a non-exclusive license providing for the payment of a royalty based on productivity or the U.S. party may incur incremental tax costs. For example, selling technology for a lump sum payment will result in an effective tax burden equal to the combined U.S. and host country taxes if the U.S. person is not be able to claim foreign tax credits for host country withholding tax. *See supra* Part IV.

2. Instead of an engineering services contract, the U.S. person should consider whether it is appropriate to enter into a cost sharing arrangement with the potential joint venture partner pursuant to which the parties would share development costs, jointly own any resulting technology in proportion to their contributions to the arrangement (including the value of technology furnished), and license it to the joint venture. *See Reg. Section 1.482-7T.*

D. **Individual Business Travelers**

1. U.S. individuals spending more than a certain amount of time during any calendar year in the host country are required to file local income tax returns and pay host country individual income taxes.
a. Internal tax law usually specifies a number of days of presence as triggering tax liability.

b. Tax treaties normally extend the number of days of presence permitted to 180 or 183 days so long as the compensation is not being deducted in the source country. Some treaties contain dollar limitations on the amount of compensation that may be earned and/or restrict the permissible payor. See Korea/United States income tax treaty Article 19.

2. Your client's employees who travel to the host country but who do not plan to become host country taxpayers should avoid spending more than the specified number of days in the country in any year and closely monitor and be prepared to prove the number of days they are present each year (the entry and exit stamps on passports and visas should be adequate so long as they are legible).

VI. MISCELLANEOUS PROVISIONS OF REVENUE RECONCILIATION ACT OF 1993, TITLE XIII, CHAPTER 1 OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993, INCLUDING THE ACCOMPANYING LEGISLATIVE REPORTS

A. Subpart F Anti-Deferral Provisions


a. The general rule is that U.S. corporations are not subject to U.S. taxation on income earned through foreign subsidiaries until the earnings are repatriated (e.g., as dividends, interest, or royalties). However, the controlled foreign corporation ("CFC") provisions of Subpart F of the Code contain a series of complex rules designed to eliminate U.S. tax deferral with respect to passive and other tax haven-type income. See Sections 951 et seq.

b. The new law amends Subpart F to provide for a deemed repatriation of untaxed profits of a CFC that has excess passive assets without regard to the type or relative amounts of income it earns. The amount of the deemed distribution is the lesser of the shareholder's pro rata share of the CFC's excess passive assets (less retained earnings previously included in the shareholder's income on account of excess passive assets under Section 956A and investments in U.S. property under Section 956) or the CFC's applicable earnings. Section 956A(a). The new provision is effective for tax years of a foreign corporation beginning after September 30, 1993 and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. Sections 951(a)(1)(C), 956A.
(1) The general intent of the new provision is to impose current U.S. tax when a CFC invests accumulated business earnings in passive assets instead of reinvesting them in the business or repatriating them.

c. Excess passive foreign assets is the amount by which passive income-producing assets exceed 25% of total assets, each quarter. The computation is based on adjusted asset basis for E&P purposes. Section 956A(c).

(1) Passive assets are assets that produce or are held for the production of passive income as defined in Section 1296(b) of the passive foreign investment company rules.

(a) A lookthrough rule applies to characterize assets involving payments from related persons. Sections 956A(c)(3)(A), 1296(c).

(b) Certain assets are excepted from treatment as passive assets, including certain related party stock and debt, certain receivables factored within a CFC group, and U.S. property within the meaning of Section 956. Sections 956A(c)(2), (3), 1297(d), (e); Conference Report at 165.

(c) The adjusted basis of total assets is increased by certain R&D expenses and the capitalized value of licensed intangibles and leased assets. Sections 956A(c)(3)(C) and 1297(e).

(2) Certain members of a CFC group are treated as one corporation and their assets are pooled or aggregated. Section 956A(d)(1). If the group of CFCs as a whole has excess passive assets, the excess is allocated among the group based on each CFC’s percentage of applicable earnings, which can produce a deemed dividend from a CFC with no passive assets. Section 956A(d)(1)(B).

(a) The lookthrough rules do not apply in the case of related party stock or debt within a CFC group that is disregarded for purposes of the aggregation rules. Conference Report at 165.

(b) Treasury is given authority to promulgate currency translation rules. In the meantime, any reasonable method, including a spot rate conversion or historical dollar cost, may be used. Conference Report at 166.
d. Applicable earnings are current and accumulated earnings and profits for taxable years beginning after September 30, 1993, less actual distributions and previously taxed amounts under Sections 956 or 956A accumulated in taxable years beginning after September 30, 1993.

e. This provision will eliminate U.S. tax deferral currently applicable to the foreign active business earnings of many U.S.-based multinationals, particularly those with foreign finance operations (they typically have substantial passive income-producing assets). U.S. multinational taxpayers will likely take a number of steps to deal with this new rule.

(1) Evaluate the effect of potential Section 956A inclusions based on the taxpayer's foreign tax credit position and the extent to which the additional income carries foreign tax credits.

(2) Engage in corporate restructuring to isolate affected and non-affected CFCs and limit the effect of the grouping rule.

(a) However, the Internal Revenue Service is given regulatory authority to prevent avoidance of the provisions through reorganizations or otherwise. Section 956A(f).

(3) Engage in related party transactions that have the effect of increasing active assets. Make sure that intercompany loans do not have the effect under the lookthrough rules of generating passive income and thus making the lender's assets passive.

(a) For example, use loans between brother-sister CFC groups involving borrowers engaged in active businesses to characterize assets as non-passive under the lookthrough rules. Have foreign subsidiaries enter into licenses, which will be capitalized as active assets.

(b) The Conference Report indicates that transactions the principal purpose of which is the increase active assets may be disregarded. An example of such an abuse would be routing licenses to third parties through a CFC to increase its active assets. See Conference Report at 168.

(4) Locate new active businesses overseas to put active assets in CFC groups.
(5) Consider whether it is better to finance expansions and acquisitions with accumulated earnings instead of debt because the passive asset test is based on assets without regard to debt.

(6) Consider the impact of the rules on the timing of equity contributions and loans to foreign subsidiaries.

2. **Section 956 Loans to Related Parties.**

   a. Section 956 treats certain increases in a CFC’s investment in U.S. property as deemed repatriations of earnings subject to tax as a dividend under Subpart F. The increase generally is measured by comparing close of prior year amounts with close of current year amounts.

   b. The new law revises the computation of the amount includible under Section 956, making it the lesser of the shareholder’s pro rata share of (i) the average amount of U.S. property held by the CFC, computed on a quarterly basis (less amounts previously included under Section 956), or (ii) the applicable earnings of the CFC. Section 956(a).

      (1) The amount taken into account is the asset’s adjusted basis less liabilities to which the property is subject.

      (2) The applicable earnings are the same amount as computed under new Section 956A, except that pre-October 1, 1993 earnings are included. Section 956(b)(1).

      (3) The changes generally simply parallel the rules relating to excess passive assets.

   c. The quarterly computation of U.S. property held by the CFC will make it more difficult to use CFC funds for short terms during the year without incurring a deemed inclusion. It also will make it more difficult to use Section 956 affirmatively to trigger dividends at the end of the year due to the substantial amount of increased investment required to account for quarterly averaging.

   d. The Internal Revenue Service is given authority to prevent the avoidance of Section 956 through reorganizations or otherwise. Section 956(e). The Conference Report indicates concern that taxpayers may attempt to take advantage of differences between the excess passive asset rules and the rules of Section 965. Conference Report at 169.
3. Same Country Exception.

a. Certain dividends received by a CFC located in the same country as the payor CFC are excluded from characterization as Subpart F foreign personal holding company income subject to current taxation. Section 954(c)(3)(A)(i). This provision facilitates the use of same country holding companies.

b. Under the new law, the exclusion applies only if the dividend is from earnings and profits accumulated during the period the recipient held the stock, directly or indirectly through a chain of corporations, of the distributing corporation. Section 954(c)(3)(C).

c. This provision may restrict the ability to use cross-chain sales of stock to restructure foreign operations under Section 304 where the resulting deemed distributions are disqualified from the same country exclusion. See, e.g., Rev. Rul. 91-5, 1991-1 C.B. 114, Rev. Rul. 92-85, 1992-2 C.B. 69, and 92-86, 1992-2 C.B. 199. Same country dividends will not be able to be paid in or following such a restructuring because the exception only applies where there was direct ownership or indirect ownership through a chain.

4. Previously Taxed Income.

a. The computation of the foreign tax credit limitation under Section 960 on the distribution of previously taxed income has been simplified through the use of an "excess limitation account" for distributions attributable to previously taxed income from years when the taxpayer was in an excess foreign tax credit position.

b. The ordering rules for distributions of previously taxed income have been changed and may result in greater current inclusions under Subpart F. Section 959(a), (c), (f).

B. Passive Foreign Investment Companies ("PFICs")

1. The passive foreign investment company rules impose an interest charge designed to take away the benefits of tax deferral with respect to U.S. shareholder interests in foreign corporations that have significant amounts of passive assets or passive income. Sections 1291 et seq. They act as a backstop to Subpart F.

a. Under Section 1296(a)(2), a foreign corporation is a PFIC if its average percentage of assets (by value) during the year that produce, or are held for the production of, passive income is at least 50 percent.
b. Previously, foreign corporations were permitted, but not required, to make the determination by adjusted asset basis.

c. The new law generally makes changes to the rules relating to PFICs that are CFCs.

2. Under the new law, a CFC is required to make the computation under the passive asset test using the adjusted basis of its assets for earnings and profits purposes instead of using the fair market value of the assets. Section 1296(a).

   a. Asset basis is increased for recently incurred Section 174 research and experimental expense and the capitalized value of certain licensed intangibles and leased property. Section 1297(d), (e).

   b. An exclusion from the definition of passive income is provided for income derived by a CFC registered as a securities broker or dealer in the conduct of a securities business. By statute, the IRS has the authority to extend the exclusion to nonregistered brokers and dealers, and the Conference Report appears to sanction its application to banking and insurance businesses. The exclusion does not apply to financing and credit services businesses, although Treasury is to prepare a report by March 1, 1994 regarding extension to such businesses. See Conference Report at 167.

3. The definition of a PFIC distribution has been expanded to include deemed dividends under Sections 956 and 956A, which could trigger the PFIC interest charge. Section 1297(b)(9).

4. Although the new Section 956A rules will frequently apply instead of the PFIC provisions, the use of adjusted basis makes it more likely that companies with depreciated and other lower basis operating assets (e.g., self-developed intangibles) will be classified as PFICs.

C. R&D Expense Allocation

1. The research and development ("R&D") expense allocation rules of Section 864(f) provide rules for the allocation of R&D expense between U.S. and foreign sources for foreign tax credit limitation purposes.

2. The new law extends the current rules for one year beyond the period provided in Rev. Proc. 92-56, except that it reduces the amount of U.S. R&D cost allocated to U.S. sources from 64% to 50%.

   a. The remainder of the income is apportioned on the basis of sales or gross income.
3. The reduction in the percentage allocated to U.S. sources will have the effect of increasing the amount of R&D expense allocated to foreign sources, which in turn will reduce the foreign tax credit limitation for U.S.-based multinational taxpayers conducting such activities in the United States.

D. Section 482 Penalty for Intercompany Transfer Pricing Violations

1. Section 6662 provides for the imposition of substantial penalties for valuation misstatements and other violations of the intercompany transfer pricing rules of Section 482, unless the error is due to reasonable cause.

2. The new law reduces the threshold for imposing the 20 percent valuation misstatement penalty from $10 million to the lesser of $5 million or 10% of gross receipts. Section 6662(e)(1)(B)(ii).

3. The new law reduces the threshold for imposing the 40 percent valuation misstatement penalty to the lesser of $20 million or 20% of gross receipts. Section 6662(h)(2)(A)(iii).

4. The new law codifies the requirements contained in proposed Treasury regulations for contemporaneous documentation of transfer pricing policies to qualify for the reasonable cause exception to the Section 6662 penalties effective for tax years beginning after December 31, 1993. Section 6662(e)(3)(B), (D).

5. These changes put more pressure on a multinational's transfer pricing policies, require multinational companies carefully to document pricing methods (with supporting economic analysis) when transactions are entered into, and provide more incentive for the use of advance pricing agreements.

E. Portfolio Interest Rules

1. The portfolio interest rules permit the payment of certain interest to foreign persons without the imposition of withholding tax. Sections 871(h), 881(c).

a. U.S. multinationals use the portfolio interest rules to borrow at favorable interest rates from foreign persons that are not residents of treaty countries or that wish to hold bearer obligations.

b. Participating or "equity kicker" loans are frequently used to obtain foreign financing for U.S. real estate projects. The lender may be given a stated interest rate and additional interest based on the appreciation in value of the property, thus effectively permitting the lender to share in real estate profits without becoming subject to tax
under Section 897 (FIRPTA, the Foreign Investment in Real Property Tax Act of 1980).

2. Under the new law, the portfolio interest exception no longer applies to "equity-kicker" interest received after December 31, 1993, including interest based on gross or net income or profits; sales receipts or other cash flow; or change in value of property, dividends, or partnership distributions of the debtor or a related person. Section 871(h)(4).
   a. Existing fixed-term obligations issued on or before April 7, 1993 are grandfathered.
   b. There are certain exceptions for participations tied to the consumer price index or certain other indices.
   c. The new rule does not affect the treatment of contingent interest under a treaty, which may still permit a "participating" foreign lender to obtain reduced rates of withholding tax.

F. Anti-Conduit Rules

1. Treasury is given authority to promulgate regulations regarding back-to-back loans and other multiparty financing arrangements, including those involving guarantees or equity, to prevent the avoidance of tax. Section 7701(l).

2. The main import of these provisions will be to strengthen the Internal Revenue Service's efforts to combat conduit arrangements, which it has been doing through administrative pronouncements that were cited approvingly in the Conference Report at 186. See, e.g., Rev. Rul. 87-89, 1987-2 C.B. 195, Rev. Rul. 84-152, 1984-2 C.B. 381, Rev. Rul. 84-153, 1984-2 C.B. 383; PLR 9133004; GCMs 39845-39851.

G. Earnings Stripping

1. Section 163(j) prevents so-called earnings stripping (the reduction of U.S. corporate income taxable income through interest payments subject to little or no withholding tax) if interest is paid to a foreign related party, the borrower's debt-to-equity ratio is greater than 1.5:1, and its net interest expense exceeds 50% of its adjusted taxable income.

2. Section 163(j) was amended by the new law to treat loans from unrelated parties as related party debt if they are guaranteed by tax-exempt or foreign related parties if the lender is not subject to gross basis taxation (withholding tax). Section 163(j)(3)(D).
a. In effect, this treats the third-party debt of a U.S. company as a back-to-back loan from the lender to the guarantor and then from the guarantor to the company. It could apply, for example, to a U.S. bank loan to a foreign owned domestic corporation to recharacterize the loan as related party debt from the foreign shareholder.

b. Guarantees are broadly defined to include any arrangement pursuant to which a person assumes, conditionally or unconditionally, the payment of another's obligation.

c. The new rules, which apply to taxable years beginning after December 31, 1993, do not grandfather existing debt.

3. The new law will require many foreign owned domestic corporations to revise their capital structure to avoid the loss of interest deductions and will increase the U.S. taxable income of such companies significantly.

H. Section 936 Possessions Credit

1. Section 936 eliminates U.S. tax with respect to certain business operations conducted in U.S. possessions.

2. The new law restricts the benefits of the possessions credit to one of the two following alternatives:
   a. 60% of the benefit computed under prior law, phasing out at a rate of 5% a year until it is down to 40% by 1998.
   b. A formulary credit that is computed based on qualified possessions compensation, depreciation deductions, and income taxes paid. Section 935(i).

I. Amortization of Intangibles

1. The new law expands the scope of intangible property subject to amortization but generally requires that it be amortized over a 15 year period without regard to the actual useful life of the property. It affects assets such as goodwill, franchises, trademarks, data and information bases, computer software, copyrights, patents, trade secrets, customer lists, and covenants not to compete. Section 197.

2. From an international tax standpoint, new Section 197 will affect the computation of earnings and profits for foreign tax credit purposes, particularly in the case of the acquisition of foreign operations or a foreign corporation for which a Section 338 election is made to step up asset basis and purge the target's tax history.
VII. SELECTED BIBLIOGRAPHY


