International Income Taxation

Chapter 13
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Alternative foreign investment situations:
Cf., Direct vs. Portfolio Investment

Alternative direct investment structures:

1) Foreign branch of a U.S. corporation (or a foreign branch of a U.S. subsidiary)
2) Foreign country subsidiary
3) Third country (foreign) subsidiary (and branch in the destination country?).
Use (i) U.S. parent corporation or (ii) a special purpose U.S. (or foreign) subsidiary. General Thoughts on “Branches”

1) Branch will enable U.S. tax deductions, e.g., minerals and oil and gas exploration and
2) Branch will enable consolidated return treatment (loss utilization, but “recapture”).
3) No limitation of liability for foreign branch assets – but, use a special purpose U.S. subsidiary for only holding this investment.
If a corporation, deferral of U.S. income tax is available, assuming inapplicability of Subpart F (e.g., if active business operations and tax holidays in the foreign country).

Organization of a foreign corporation may accommodate joint foreign investors.

What form of foreign business entity should be used to enable corporate status? LLC?

Use a “hybrid entity” or a corp. in the foreign country?
Western (U.S.) is engaged in U.S. mining.

Planning a mining venture in Country Z.

Initial capital of $300 million in equity.

Terms of the “deal” in the foreign country:

Royalty to be paid for the mineral product;
Foreign income tax of 30% on net profits;
No withholding tax on div. or royalties;
Deduction for royalty for process patent.

Country Z Tax:
Profit before royalty $50,000,000
Royalty < 5,000,000>
Net profit 45,000,000
Country Z income tax (30%) <13,500,000>
Profit after Country Z tax $31,500,000
Problem
Tax/Financial Analysis

Use a branch of the U.S. corporation or a foreign corporation?

**Subsidiary Analysis ($5 million royalty)**

- **Royalty**: $5,000,000
- **Dividend & §78 Gross-up**: $21,428,571
- **US tax b/4 credits**: $9,250,000
- **§902 Credits**: $6,428,571
- **Residual US Tax**: $2,821,429
- **E&P/(General) Taxes (General)**: $31,500,000
  - **<15,000,000>**: $6,428,571
  - **<15,000,000>**: $7,071,429

**Country Z Tax:**
- **Profit before royalty**: $50,000,000
- **Royalty**: < 5,000,000>
- **Net profit**: 45,000,000
- **Country Z income tax (30%)**: <13,500,000>
- **Profit after Country Z tax**: $31,500,000
Branch Analysis ($5 million royalty)

Western/Process Tax Analysis:
- Royalty: $5,000,000
- Earnings after royalty: $45,000,000
- *Percentage depletion: $22,500,000
- Taxable Income: $27,500,000

US tax b/4 credits: $9,625,000
§901 Credits: $13,500,000
Residual US Tax: -0-
Excess Credits: $3,875,000

Note: This percentage depletion deduction is only given to US taxpayers, not to CFCs. The existence of this “extra” US deduction creates an exception to the general rule that low-taxed income achieves a lower US tax cost if earned in a CFC.

Country Z Tax:
- Profit before royalty: $50,000,000
- Royalty: $5,000,000
- Net profit: 45,000,000
- Country Z income tax (30%): $13,500,000
- Profit after Country Z tax: $31,500,000
Necessary to have limitation of liability?

Use a corporation or a (non-corporate) LLC?

Necessary to have two or more owners for an LLC? Use two special purpose subs in the U.S. to hold 50% (or 90 & 10%) interests.

Deferral is not important if the foreign tax rate is high as or higher than the U.S. income tax rate.
Foreign corporation in host country (and similar foreign counterparts).

Third country corporation.

Limited liability company (LLC).

Limited partnership (LP).

General partnership (GP).

Contractual joint venture (JV).
Entity Choices Outside U.S. – Business Law Aspects  p. 1081

1. Limitation of liability.

2. Control arrangement.

3. Profit sharing split.

4. Foreign country tax burden.

5. Foreign tax credit: (i) availability and (ii) excess FTC position for U.S. owner.
OLD LAW
1) Associates (both corp. or partnership).
2) Objective to carry on business and divide the profits (both corp. or partnership, not trust).
3) Continuity of life – death, insanity or bankruptcy not causing dissolution.
4) Centralized management – non-owner may have continuing authority to make management decisions.
5) Free transferability of ownership interests – owners have power, without the consent of other owners, to substitute others (not previously equity owners) for themselves in the organization;
6) Limited Liability – no equity owner is personally liable for the debts of or claims against the organization.

Inconsistent classification possible: **Hybrid entity** – a corporation for foreign law purposes but a partnership for U.S. income tax purposes. **Reverse hybrid** (U.S. corp. status; foreign flow-through).
CURRENT LAW: Treas. Reg. §301.7701-1 through -3.

Elective approach of structuring entities to be a (i) corporation or (ii) partnership for U.S. tax purposes. Permits the use of ‘hybrid entities’.

Certain business entities are automatically classified as corporations for U.S. tax purposes, including a list of specific foreign entities. Reg. §301.7701-2(b)(8).

Inconsistent Classification: now not only possible but straightforward. Easy to create hybrid and reverse hybrid entities.
Unless the foreign entity elects otherwise:

1) Treated as association (and a corporation) if all members have limited ability;

2) Treated as a partnership if it has two or more members and at least one member does not have limited liability; or

3) Disregarded as an entity separate from its owner if only a single owner that does not have limited liability.
Federal income tax effects:

1) Eligibility entity (partnership or disregarded entity) elects corporate status – a §351 incorporation transaction.

2) Eligible entity treated as a corporation elects partnership status – treated as a corporation liquidation and a contribution of assets to a partnership.
Second Example on p. 1093

Estimate: 45%  
Actual: 50%

USC  
(US)

Finance Co  
Actual Tax Rate: 5%

FC #1  
(Country A)

Manufacturing  
Actual Tax Rate: 40%

FC #2  
(Country B)

Result: Manufacturing exception for FC #2 earnings and payments to FC #1 are non-events

Example on p. 1094

Estimate: 45%  
Actual: 50%

USC  
(US)

FC #1  
(Country A)

Cash

Buyer

FC #2 Shares

Result: FC #2 share sales is treated as a sale of active business assets and thus not subject to FPHCI. Opens up “check & sell” planning. See Dover Case. p. 1095.
Notice 98-11 – separate entity status for hybrids?

Temporary Regs. – T.D. 8767. Seeks to treat hybrids as separate entities

Notice 98-35 – withdrawing these items

Proposed Regs. 1.954-9 (1999), pending (effective 5 years after finalized)

Proposed “Extraordinary Transaction” Rule

Withdrawal of this Rule – Notice 2003-46

**Issue**: Should IRS be able to promulgate a “branch rule” for FPHC income?
Treat as a *corporation* for U.S. tax purposes the foreign entity which:

1) Is a separate business entity organized under foreign law; and,

2) Is a separate entity having only *one* member.

And, possible regs to preclude the division of ownership to avoid this corp. status rule.
U.S. corporation is permitted to file a consolidated tax return with affiliated corporations. Losses of one group U.S. member can offset the income of another U.S. group member. §1504.

Another country may treat the corporation as resident-management and control test.

Dual resident corps cannot “double dip” for losses. §1503(d).

Result: US Holdco (managed & controlled in UK but US corporation) is a dual resident, so its interest deduction is deducted in the UK consolidated return and the US consolidated return (double deduction).
Structuring of arrangements to enable reduction of overall effective foreign tax rate:

1) Lending money and generating interest expense deduction and lower withholding rate of the outbound interest payment.

2) Export of goods – pass title to (i) generate foreign source income and (ii) avoid any income tax in the foreign jurisdiction.

3) Technology licensing arrangement with the foreign subsidiary and extraction of low/no taxed, deductible royalty, to which the look-through rules are applicable for FTC.

4) Managerial and technical services in foreign country – same planning objective, i.e., deductibility of payment for local country income tax and low/no withholding tax at source.
Use debt or special class(es) of stock?

Is the interest on the debt deductible for foreign country income tax purposes?

And, FTC “look-through” rule. §904(d)(3).

Debt arrangement enables the tax-free repayment of principal (not treated as dividend) and is free of the applicability of the withholding at source rules (if treaty).

Cf., stock redemption subject to §302.

Below shows capitalization question: if deferral were the goal, then lend from FC#1. If repatriation is the goal, then can lend from USC.
Transfer of tangible property and intangibles as:

1) Contribution to capital (consider §§351 & 367(d)) (ordinary income), or

2) Sale, lease or license (consider §482).

Consider (a) applicability of sourcing rules and (b) tax characterization rules – ordinary income or capital gain.