TAX ASPECTS OF FINANCING THE PACIFIC BASIN ENTERPRISE

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I. INTRODUCTION

The perspective of this article is that of the U.S. advisor because the author is a U.S. trained lawyer. Reliance is placed on foreign counsel for expertise in foreign law.

The fact patterns that usually confront a U.S. advisor fall into one of two categories—outbound or inbound transactions. An "outbound" transaction involves the situation in which an American company or individual plans overseas commercial activity. That activity may involve the rendering of services, the sale or manufacture of a product, the purchase of a product or any combination of these elements. The anticipated period of activity may be limited to a single transaction or may be open-ended.

An "inbound transaction" is one which involves a foreign based operator engaging in commerce in the United States either for the purpose of making an investment in the U.S. or engaging in an active business.

The rules that apply to each transaction and the considerations to be weighed are strikingly different and thus much of this paper is concerned with the outbound-inbound dichotomy.

The focus of the article is on tax considerations. However, in order to indicate the context in which the tax factors are raised various other investment concerns are listed. Included in the context of investment factors are start-up costs, potential market,

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profit potential, proper structures, and a myriad of matters peculiar to the type of business to be entered.

Concerning the various types of taxes discussed, non-income taxes as well as income taxes are analyzed. Concerning income taxes, foreign as well as U.S. taxes are considered.

II. OUTBOUND TRANSACTIONS

A. Investment Considerations

1. *Determination of Profit*. All investments share one common motive—profit. As obvious as this statement may seem, it is not always apparent how profit is to be measured or whether an investor has thought about profit in the proper terms. If profit is to be measured in terms of the growth of value of the foreign currency where the investment is made, the investor will weigh a set of factors that is different than if he intends to bring the earnings home at periodic intervals. For example, if an American corporation elects to open a branch or a subsidiary in France, the enterprise may show steady growth in terms of French francs but may be flat or indeed show a loss when the figures are translated into U.S. dollars.

Since, ultimately, the score for a U.S. investor only makes sense in U.S. dollars, a key consideration of any investment is the projected inflation rate of the foreign currency compared to the U.S. dollar.

2. *Start-up Costs*. Determining with accuracy the start-up costs for a domestic venture is a difficult task. When the venture is located a few thousand miles from home the difficulties are multiplied. Hence, no matter how accurate the estimate of the costs appear, it is axiomatic that the estimate is wrong. Unfortunately, the estimate is almost always low. To at least soften the blow, a contingency factor should be built into every estimate. Moreover, the size of the contingency should be in inverse proportion to the investor's experience in the particular foreign country; that is, the new investor in the particular country should have a larger contingency factor than the more experienced investor.

3. *Financing*. Every investment begins with money. A fundamental problem for every investor is putting together the needed sources of funding. If the investment is relatively small (as might be the case in a service-oriented business) the question of funding may be of little significance. In most other investments, however, the question of funding is critical.

Generally, the immediate source of funding to begin the project is a local foreign bank which will issue the desired loan in

local foreign currency. The source of ongoing credit to finance business operations, however, will often be the investor's U.S. bank. This arrangement will be somewhat more costly because usually the borrower will be paying a foreign bank interest at the foreign rate as well as paying a U.S. bank a commitment or letter of credit fee.

If the business is an export business, help may be available from sources not available to the purely domestic business such as the U.S. Export-Import Bank. In addition if the new business will involve substantial capital infusion to the foreign country and the creation of jobs, the foreign government may have significant cash and credit subsidies available.

4. *Corporate Structure*. Choice of the proper corporate structure requires consideration of factors pertinent to both the U.S. and the foreign country. If the investment is to be passive, as for example a minority position in a real estate venture, the investor may choose among investing through a U.S. corporation, a local corporation or a third-country corporation. The factors to be weighed include local law (e.g., personal liability for debts of the enterprise) local taxes, U.S. taxes and third-country rules.

Answers require the joint work of foreign as well as U.S. advisors.

5. *Special Businesses*. A recurring difficulty encountered by the overseas American investor is the special set of rules established to protect some local businesses. One can anticipate such protection in certain industries which include banking and trust activities, insurance, military/defense related businesses and transportation. Also, the list frequently includes medical and pharmaceutical businesses.

If one plans to enter into an industry in which domestic businesses are protected, the start-up cost and start-up time will frequently be several times that of a non-protected business.

6. *Insurance*. Insurance considerations for the U.S. investor require that local foreign assistance be obtained to purchase ordinary casualty insurance (for example fire, theft, riot, vandalism and the like) and in addition that expropriation insurance be purchased, especially if the investment is in the third-world.

7. *Repatriation*. Since the motive for the investment is to make a profit, the question of repatriation of both the original investment and the anticipated profit should be addressed. If the foreign country of investment has limitations on the export of capital, an investor may take advantage of a country's need for U.S.

dollars as a basis for negotiating a repatriation agreement. Such an agreement usually can only be negotiated before the investment is made, however.

8. *Conclusion*. The foregoing list of factors to be considered when analyzing a foreign investment is obviously superficial. The list is not complete, nor is the discussion in sufficient depth to do other than raise questions. It is designed, however, to be a check list for further study.

B. Tax Considerations

1. Non-Income Tax Considerations.

a. *Capital and other taxes*. Capital taxes, maintenance or wealth taxes and transaction taxes tend to be more costly in many foreign countries than in the United States. Hong Kong real estate transfer taxes are, by American standards, exorbitant. In addition, many foreign countries have wealth taxes which may affect individual employees. Local counsel should be consulted concerning these and other taxes that may be applicable.

The United States does not have any non-income taxes with which the outbound transferor need be concerned.

b. *Death taxes*. Gift and death duties vary significantly from country to country, again, a matter for local counsel. Note that if a U.S. expatriate dies in a foreign country with the result that both the foreign country and the United States assert tax jurisdiction, the heirs may be able to utilize the estate tax credit[1] to reduce the overall estate tax burden.

2. Income Tax Considerations

a. Branch Operation

i. *In general*. If the investment is to be a branch of a U.S. company (for this purpose "branch" includes a foreign operation by a wholly owned U.S. subsidiary—other than a DISC—even if its only operations are conducted in the foreign country), the tax considerations are more limited than if the investment is to be made through a foreign subsidiary.

The branch of a U.S. company is not concerned with I.R.C. sections 367 or 482. I.R.C. section 367 imposes a duty on the U.S. transferor to apply for a ruling from the Internal Revenue Service, only if he transfers property to a foreign corporation, even when wholly owned. I.R.C. section 482 authorizes the Service to reallocate income and deductions among related entities when the Serv-

1. I.R.C. § 2014 (1982).

ice deems reallocation to be appropriate in order to properly reflect income.

These two provisions are inapplicable to a branch because the corporate enterprise is treated as a unit, irrespective of the locale of its operations. The corporation reflects the results of its world-wide operations on its tax return each year in which it generates a profit or loss. Consequently, a physical transfer of property overseas is not a transfer for tax purposes.

The tax considerations with which the entity is concerned, however, include: the foreign tax credit provisions, allocation of deductions between U.S. and foreign operations, the U.S. treaty network, the appropriateness of using a DISC, foreign currency gains and losses, taxation of U.S. personnel, and local taxes.

ii. *The Foreign Tax Credit*. The rationale of the foreign tax credit is that the American taxpayer, earning income in a foreign country and paying tax to the host country on that income, should not pay a second tax to the United States. Consequently, taxes paid to a foreign country on foreign source income are treated as a credit against U.S. tax liability on that income.[2]

The difficulty with this simply stated rule is that the mechanics of the foreign tax credit are complex and difficult to understand. Perhaps the most difficult rule is the limit on the amount of the tax credit under I.R.C. section 904. In theory, the limit should equal the amount of U.S. income tax that is due on the foreign income.

> *Example*. Rhoco Corp. is a California corporation with manufacturing operations in the United States and France. Rhoco's net earnings from its U.S. and foreign operations are as follows
>
> U.S.: $10,000,000 Foreign: $2,000,000
>
> Total: $12,000,000
>
> On that income, assume the effective rate of tax is 46 percent in the U.S. and 50 percent in France. The total U.S. tax (pre credit) would be $5.5 million; the tax paid to France would be $1 million. Without the limitation provisions, the entire one million would act as a credit against the U.S. tax. But note that if that result were indeed allowed, the French tax in part would reduce the amount of tax due on the U.S. source income and hence the limitation provisions.

The limitation provision is a formula:

$$\text{U.S. (pre credit) tax} \times \frac{\text{Foreign source income}}{\text{Worldwide income}} = \text{foreign tax credit}$$

2. I.R.C. § 901 (1982).

Example. Returning to the prior example, the formula in dollars is as follows

$$5{,}500{,}000 \times \frac{2{,}000{,}000}{12{,}000{,}000} = 916{,}667, \text{ the allowable FTC}$$

The remaining $83,000 of tax paid to France is classified as excess foreign tax credit and can be carried backward or forward to other years.

Note that under the formula the total tax paid to both France and the United States is $5,583,333. Thus, Rhoco's effective tax rate worldwide is in excess of the U.S. rate of 46 percent.

There are an extraordinary number of technical points in the rules that comprise the foreign tax credit. The list is too long to set out at this point but provides the explanation why almost every major multinational is staffed with its own experts in the foreign tax credit area.

iii. *Deductions*. One of the continuing problems faced by a multinational is the proper handling of deductions. Certainly all deductible expenses are fully deductible from worldwide income; the crucial question is whether the deduction should be sourced in the United States or the foreign country. The importance of this issue is found in the foreign tax credit calculation. Thus, if a taxpayer has $1,000,000 worth of deductions that are United States deductions, the denominator of the factor applied to the U.S. tax alone is affected. Assume, for example, the formula looks like this before the deduction:

$$\$5{,}000\text{M} \times \frac{3{,}000\text{M}}{10{,}000\text{M}} = 1{,}500\text{M allowable credit}$$

If, however, you factor in the expense as a U.S. deduction only, the formula looks like this:

$$\$4{,}500\text{M} \times \frac{3{,}000\text{M}}{9{,}000\text{M}} = 1{,}500\text{M}$$

Basically, the limitation does not change in this instance. Note the result, however, if the $1,000M deduction were allocated entirely to the foreign source income:

$$4{,}500\text{M} \times \frac{2{,}000\text{M}}{9{,}000\text{M}} = 1{,}000$$

Merely by allocating the deduction to the foreign income the foreign tax credit is reduced by one-third. Hence, understanding the rules relating to the allocations of deductions is important.

The regulations that tell the taxpayer (more or less) how to handle deductions are found in regulations section 1.861-8. The basic rule which the regulations set forth is that the taxpayer is required to "allocate" deductions to a "class of income" and then, if necessary, to "apportion" the deductions within the class of gross income between the "statutory grouping" and the "residual grouping" of the class of gross income to which the deduction is allocated.

The method involved in taking those steps is quite complex. Major accounting firms have developed computer programs to assist them in applying those rules. In addition to the general rules relating to allocation and apportionment, there are rules applied to interest, research and development, stewardship expenses, legal and accounting expenses, income taxes, losses on the sales of property and operating losses.

iv. *Treaty considerations*. In the Pacific Basin the U.S. has few treaty partners. Japan, Korea, the Philippines, Australia and New Zealand are the only income tax treaty partners.

The treaties have generally similar provisions. They usually provide for reduced withholding on interest, dividends and royalties when paid by a resident of one treaty country to a resident of another. Further, the treaties provide that engaging in business in the treaty country will be taxable by that country only if the business is carried on through "a permanent establishment."

The treaties contain a number of other provisions each of which is significant at times.

Each treaty is, in effect, an amendment to the Internal Revenue Code. As a general rule, if a provision of the Code conflicts with a treaty provision, the treaty provision will control. The treaty is always beneficial, however. A taxpayer may choose not to utilize a treaty in the unlikely event he finds it more beneficial to apply the general provisions of the Code.

The benefits of an income tax treaty are limited to the foreign party operating within a treaty signatory. Thus, the American who has foreign operations can use the treaty to his benefit in the foreign country but he can not use it to reduce his U.S. tax obligation.

If the U.S. businessman is planning operations in a country of a U.S. treaty partner, he should carefully examine his proposed operations in light of the treaty provisions. That recommendation is particularly important if the net effective foreign tax rate is higher than the U.S. net effective rate on the same income.

b. Operating Through a Subsidiary

i. *In general*. The taxpayer must have a fair understanding of the different rules that apply to a foreign subsidiary and a foreign branch of a domestic corporation. A foreign subsidiary is any corporation owned by the domestic parent that is created in a foreign country. Thus, even if the subsidiary has all U.S. directors and U.S. officers, it is nevertheless a foreign corporation solely by reason of its being incorporated in a foreign country.[3]

In weighing whether to use a foreign corporation, the taxpayer should understand that the corporation will be classified as a controlled foreign corporation. As such, the provisions of I.R.C. sections 951 *et seq.* will apply. Those sections do not have a direct impact on the subsidiary but rather instruct the U.S. corporate shareholder on the treatment of the subsidiary's income. If the subsidiary earns what the Code calls Subpart F income in sufficient amount (10 percent of gross income) the net Subpart F income is treated as a dividend to the U.S. parent. (More about that subject below.)

Utilizing a foreign corporation raises additional issues of concern for the U.S. parent corporation.

ii. *The cost of transferring assets (I.R.C. section 367)*. If a U.S. person transfers appreciated property to a foreign corporation while incorporating, the taxpayer may realize income in what would normally be a tax-free transaction. In order to avoid realizing income, the taxpayer must obtain a favorable ruling that the transfer does not have as one of its principal purposes the avoidance of U.S. income taxes. If that ruling is not forthcoming, the transfer is treated as taxable at either ordinary or capital gains rates, depending on the character of the asset transferred.

Frequently, the ruling is issued upon the condition that the taxpayer pay a toll charge—that is a tax which may be less than, equal to or at times greater than the tax that would be due if the transaction proceeded without a ruling.

Although the Code at one time demanded that the ruling be in place before the transaction occurred, the law now requires only that the ruling be requested within 183 days of the commencement of the transaction.[4]

For guidance in applying the rather complex rules of the section, the taxpayer should refer to the temporary regulations[5] and what has come to be known as the Guidelines.[6] Revenue procedure 68-23 contains the basic set of Guidelines but revenue proce-

3. I.R.C. § 7701(a)(4) and (5) (1982).
4. I.R.C. § 367(a)(1) (1982).
5. Temp. Treas. Reg. §§ 7.367(a)-1 through 7.367(c)-2 (1977).
6. Rev. Proc. 68-23, 1968-1 C.B. 821.

dures 75-29,[7] 76-20,[8] 77-17[9] and 80-14[10] need to be consulted for a complete statement of the Guidelines.

Under the Guidelines, a favorable ruling will probably issue without a toll charge if the property being transferred is to be devoted to the active conduct of an overseas business.[11] If, however, the property transferred is income producing property, the ruling will be issued only upon payment of the toll charge. Examples of such property include inventory, intangible assets, accounts receivable, stocks or securities.

iii. *Allocation issues* (I.R.C. section 482). Under Federal law the Internal Revenue Service has the power to allocate among taxpayers, which are owned or controlled by the same interests, income, deductions, credits or allowances in order to prevent avoidance of taxes or to reflect more clearly income.[12]

That section covers not only all forms of entities but also covers U.S. and foreign entities. Indeed, the regulations specifically provide that an entity may be included in a controlled group "irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign."[13]

Note that the two entities involved must be owned or controlled by the same interests which does not mean legal control but actual control. Conversely, if the two or three entities involved in any transaction are not controlled by the same interests then the section simply does not apply.[14]

The most common application and use of the provisions of section 482 is found in the pricing area. Although this paper is not the proper forum for a lengthy dissertation on the section or the regulations on pricing, an overview of those regulations is valuable. The problem might arise in the following context.

> *Example*. Rhoco, Inc., a California corporation has a wholly owned subsidiary, Rhoco San Juan, Inc. Rhoco San Juan, Inc. is a Delaware corporation operating wholly within Puerto Rico in a manner designed to obtain the benefits not only of I.R.C. section 936 (the tax credit granted to certain domestic corporations deriving a substantial part of their income from a U.S. possession) but also to take advantage of the tax holiday provisions authorized by Puerto Rican law. Rhoco San

7. Rev. Proc. 75-29, 1975-1 C.B. 754.
8. Rev. Proc. 76-20, 1976-1 C.B. 560.
9. Rev. Proc. 77-17, 1977-1 C.B. 577.
10. Rev. Proc. 80-14, 1980-1 C.B. 617.
11. Rev. Proc. 68-23, 1968-1 C.B. 821 at § 3.02(1).
12. I.R.C. § 482 (1982).
13. Treas. Reg. § 1.482-1(a)(1) (1962).
14. *See, e.g.*, John L. Denning & Co. v. Comm'r, 180 F.2d 288 (10th Cir. 1950).

> Juan is in the business of manufacturing transducers, a small electronic device used by aerospace companies. For reasons primarily dealing with security the core of the transducer is manufactured by Rhoco, Inc. at its plant in Santa Monica, California and then sold to Rhoco San Juan for inclusion in the final manufactured transducer. The question which Rhoco faces is how to properly price the core unit to its wholly owned subsidiary

The regulations offer the taxpayer four pricing methods which must be applied, if possible, in the order set forth. Those methods are referred to as (1) the comparable uncontrolled price method, (2) the resale price method, (3) the cost plus method and (4) the taxpayer's method.

—1 *The comparable uncontrolled price method (Reg. § 1.482-2(e)(2))*. The uncontrolled price method applies when the taxpayer sells the same or substantially the same article to third parties as it sells to the related party. A sale will be treated as a comparable sale if the product and the circumstances of the sale to a third party are both so nearly identical to the sale between the related parties that any differences will not have a material impact on the price of the product or what differences there are will have a definite and reasonably ascertainable impact on the price.[15] Thus, if Rhoco, Inc. sold the core to other transducer manufacturers, then the price and terms under which it sold the core would guide Rhoco in determining the price at which it should sell the core to its subsidiary. If, however, the comparable uncontrolled price method is not available to Rhoco, then it is required to go to the next method and determine whether it can apply that method to arrive at a proper price.

—2 *The resale price method (Reg. § 1.482-2(e) (31))*. This method involves a number of accounting steps. The taxpayer starts with a price for which the product is ultimately sold by another party who acquired the product from Rhoco and then adjusts that price downward to an amount which is acceptable as the arms' length price. The resale price method can only be used, however, when the following four conditions are met: (a) there are no comparable uncontrolled sales; (b) an applicable resale price is available within a short time after the controlled sale is made; (c) the buyer (who is also the reseller) is basically a middle man—i.e., he does not add anything of substantial value to the product of either a tangible or intangible nature; and (d) sales information about uncontrolled resales and comparable transactions is available.[16]

The resale price method might be applicable to Rhoco if all

15. Rev. Rul. 79-216, 1979-2 C.B. 224.
16. Treas. Reg. § 1.482-2(e)(3)(iii) (1968).

of the components of the transducer were manufactured by Rhoco and they were shipped to Puerto Rico for simply winding, encasing and resale. In that situation Rhoco San Juan would not be treated as adding anything of substantial value to the product and could be considered a middleman. In most cases such as Rhoco's, the subsidiary does manufacture so that the resale price method is not available.

Even when the method is available, however, application is difficult because the guidelines offered by the regulations are broad and vague. As such they are subject to uncertain interpretation by the Internal Revenue Service auditor.

—3 *Cost plus method (Reg. § 1.482-2(e) (4))*. If neither of the prior two methods apply then the taxpayer should attempt to apply the cost plus method. Under this method, the taxpayer begins with the cost of producing the item. The taxpayer is then allowed to add to cost an "appropriate gross profit percentage" and thereafter to make certain adjustments.[17] Once again, the regulations offer such vague rules under the guise of guidelines as to be very unhelpful. Also, proper allocation of general and administrative costs as well as research and development costs to any particular product for a broadly based multinational company is exceedingly difficult. Thus, the cost plus method is of limited practical value to the taxpayer.

—4 *The taxpayer's method (Reg. § 1.482-2(e) (1) (iii))*. The regulations refer to this method as "some appropriate method of pricing other than those described." There is little doubt that the taxpayer's method is the most frequently used method of the four offered by the guidelines. Since it is the taxpayer's method, however, the taxpayer has a heavier burden of demonstrating that his method is applicable when the others are not. That means preparation. Preparation means acting before the audit starts and preferably before the price from one controlled party to another is established. Perhaps the most important participant in that preparation period is an economist. The Internal Revenue Service employs a staff of economists who work on nothing but Section 482 cases; a taxpayer should have at least equal guidance. Preferably a team should be involved consisting of the taxpayer's CPA, tax counsel and the economist. Their function would be to establish a clear record of price determination based upon an arms' length standard. The advisors realization that the burden of proof is on the taxpayer—not on the Internal Revenue Service—to establish the reasonable and arms' length basis for the pricing, cause them to understand the importance of preparation. When the taxpayer also recalls that any adverse price adjustment affects immediately

17. Treas. Reg. § 1.482-2(e)(4)(i) (1968).

the bottom line of his financial statements, then the taxpayer himself understands the need for preparation.

iv. *The rules of Subpart F.* If a U.S. corporation forms a foreign subsidiary, that subsidiary becomes classified under the Internal Revenue Code as a "controlled foreign corporation" (CFC). Technically, a CFC is any foreign corporation of which more than 50 percent of the stock is owned by "U.S. shareholders". A U.S. shareholder is any U.S. person who owns 10 percent or more of that corporation's voting stock. Thus, a foreign corporation which is owned 50 percent by an American and 50 percent by a foreign person is not a CFC (assuming, of course, that the foreign ownership is real as opposed to a disguised method of allowing the American to own the stock indirectly). In addition, a foreign corporation which is owned 50 percent by one American and 5 percent each by 10 other *unrelated* Americans is likewise not a CFC because none of the other 10 Americans would be classified as U.S. shareholders, the result being that U.S. shareholders do not own *more than* 50 percent of the voting stock of the foreign corporation.

Generally, however, the foreign corporation is owned totally or substantially by a U.S. parent corporation. In that case there is no question about the status of the foreign subsidiary as a CFC.[18]

There are three general results of classifying a foreign corporation as a CFC.

(a) The U.S. shareholders take into income on an annual basis the CFC's net Subpart F income;[19]

(b) The U.S. shareholders take into income their proportional share of earnings invested in U.S. property;[20]

(c) The U.S. shareholders treat certain earnings of the CFC as a dividend when the shares of the CFC are sold or liquidated.[21]

Subpart F income. The primary ingredient of Subpart F income is what the Internal Revenue Code calls foreign base company income. Foreign base company income is itself divided into five subparts: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income.

Each of these five categories of income is complex and diffi-

18. The rules relating to the status of a foreign corporation as a CFC are set forth in I.R.C. § 957(a), defining a controlled foreign corporation and I.R.C. § 951(b), defining a U.S. shareholder.

19. I.R.C. § 951(a)(1)(A)(i) (1982).

20. I.R.C. § 956(a)(1) (1982).

21. I.R.C. § 1248 (1982).

cult to apply; the two most important categories are the foreign base holding company income and foreign base company sales income.

Foreign personal holding company income is basically passive income such as interest, dividends, royalties, rents and the like. That category is most important to the planner because it includes gains from the sale of securities. Thus, if a first tier foreign corporation sold a second tier foreign corporation, the gain from the sale might well be classified as foreign personal holding company income.

Foreign base company sales income is any income derived by the CFC from the sale of personal property when a related party is either the buyer or the seller. For example, if Xerox wished to sell copying machines in Europe and established a Swiss subsidiary to do so, then the gain derived from the sales of the copiers by the Swiss subsidiary would be foreign base company sales income because a related party (the parent corporation) was the seller of those copiers to the Swiss company. The result is the same even though the subsidiary's sales to third parties were totally arms' length and unrelated to the parent group. Likewise, if a foreign subsidiary purchased goods on the open market and resold those goods to the parent corporation (or any other entity related to the subsidiary) then the profit would likewise be classified as foreign base company sales income. Conversely, if a foreign corporation owned by a U.S. person purchases beer in the Philippines and resells it in Europe to unrelated distributors, then the profit from that transaction would not be classified as Subpart F income because a related party is not involved in either the purchase or the sale.

In each of the other three categories of foreign base company income the same related party requirement is found.

The foreign base company rules also have a number of exclusions and special limitations which are relatively complex.[22]

Investment of earnings in U.S. property. Pursuant to I.R.C. section 956 the amount of earnings which are invested by the foreign corporation in U.S. property is treated as a constructive dividend to the shareholders of the CFC. As simple as the concept sounds, it is suprisingly complex in its application. Note that the amount to be taken into income in any given year is the amount of the increase of earnings invested in U.S. property.[23] Since the calculation is made annually the section requires the CFC's shareholder to determine what the amount of earnings invested in U.S. property was at the beginning of the year and the amount so in-

22. I.R.C. § 954(b) (1982).
23. I.R.C. § 956(a)(1) (1982).

vested at the end of the year. (The amount of earnings invested is the same as the amount which would have been a dividend had the property been distributed on the last day of the year to the U.S. shareholders.) Obviously, the amount of the increase in earnings invested is the amount determined by subtracting that invested at the beginning of the year from that invested at the end of the year.

> *Example*: Rhoco Export, Ltd. is a wholly owned CFC of Rhoco, Inc. Rhoco Export owned 50 percent of the outstanding stock of a U.S. corporation and the other 50 percent of which was owned by a friend of Rhoco's shareholder. Rhoco Export bought its shares of the U.S. corporation 15 days before the end of its fiscal year when the U.S. corporation had $100,000 of accumulated earnings and profits. At the beginning of its fiscal year Rhoco Export did not own any U.S. property. If the shares of the U.S. corporation stock had been distributed by Rhoco Export to Rhoco the result would have been a dividend to Rhoco of $200,000. Thus, Rhoco has received a constructive dividend of $200,000 as of the end of Rhoco Export's fiscal year.

The phrase "U.S. property" is not as broad in application as it sounds. The phrase includes tangible property located in the U.S., stock of a U.S. corporation (unless the U.S. corporation is publicly held and the CFC is a small investor), an obligation of a U.S. person (meaning that the parent cannot borrow for long periods from the CFC), and the right to use certain intangibles in the United States.[24] The phrase does not include U.S. debt obligations, money, bank deposits, certain research-oriented moveable property and obligations of a U.S. person which mature or are collected within one year from the time acquired.[25]

To reiterate, section 956 is complex in its application and it *must* be borne in mind in the event that the taxpayer has a CFC with retained or current earnings.

Gain from the sale of stock of a CFC. When a CFC with retained earnings that have not previously been subject to the rules of Subpart F (that is the corporation has earnings which were not previously treated as a dividend to the shareholders) is sold or liquidated the gain derived from the sale or liquidation is treated as ordinary gain to the extent of those earnings.[26] The remainder of the gain is not affected by section 1248 and presumably would be capital gain.

> *Example*. Harry Johnson formed a Hong Kong corporation to be the sole worldwide distributor of a beer made in

24. I.R.C. § 956(b)(1) (1982).
25. Treas. Reg. § 1.956-2(d)(2) (1964).
26. I.R.C. § 1248(a) (1982).

China. After five years, that corporation had grown to have retained earnings of $5,000,000 but by reason of its valuable distribution contract was worth substantially more. Harry sold his interest in the corporation for $9,000,000, all cash. Since the Hong Kong corporation was a CFC, Harry was required to reflect that gain as $5,000,000 of ordinary income and $4,000,000 of capital gain. The reason being that none of the income which the corporation earned from the distribution business was Subpart F income so all of the earnings were subject to the provisions of I.R.C. section 1248.

v. *Forms*. Prior to 1983 a taxpayer who acquired five percent or more of the stock of a foreign corporation was required to file a Form 959 within 90 days of that acquisition. If the corporation were a CFC and the shareholder were a U.S. shareholder, then he was also required to file Forms 2952 and 3646 with his annual tax returns.

All of those forms are now dated. They have been replaced by a single Form 5471 with its attendant schedules. The form is not less complex so matters are only improved in that the information can be wrapped up in a single form rather than in three. Further, it need only be filed with the annual income tax return even with respect to the portions of the return that replaces the old Form 959.

III. INBOUND TRANSACTIONS

A. Introduction

This section of the paper is devoted to the foreigner who invests in U.S. property. Although the overwhelming amount of investment made by individual investors is in real estate, a substantial amount of investment dollars find their way into businesses. This section will review some investment considerations and then tax considerations of the inbound transactions.

B. Investment Considerations

1. *Types of Investment*. Generally, the investment by a foreigner falls into two categories: those which are capital safe and those which are business-oriented. The term "capital safe" means an investment designed primarily to secure and protect the investor's capital rather than to earn a high rate of return. The investor may turn over his investment with regularity depending upon how safe a subsequent investment may appear. One of the major reasons that the United States is such an attractive haven for foreign capital is that it is secure both economically and politically. While that does not mean that any particular investment may be safe, it

does mean that every investment is effectively free of the risk of loss through expropriation or economic collapse.

The term "business-oriented" means profit motivated. The investor who falls into this category is not looking so much to the United States for safety of principal but rather for a better profit than he could make in other jurisdictions. That investor tends to be more entrepreneurally inclined.

Although virtually every foreign investor has a mix of these two goals in mind, the degree to which he forsakes profit for security (or vice versa) is reflected in the type of investment which he makes.

2. *Capital Safe*. A capital safe investment is usually a passive investment. It does not require, as a general rule, a great deal of attention or monitoring. It generally does not produce a high annual rate of return and the investor usually anticipates only moderate capital appreciation at best.

The kinds of investments which meet these standards are frequently interest producing debt instruments, stocks of widely held corporations and certain forms of real estate investments, such as warehouses with long term leases.

3. *Business or Profit Oriented Investments*. A foreign investor is able to invest in almost any form of business in which a U.S. citizen can. Other than a few businesses that require security clearances that a foreign person may have difficulty obtaining, the foreigner is as free to operate a business as a U.S. person.

Investment by a foreign person in a U.S. business involves both considerations that a U.S. person would weigh, and those which result from the foreign investor's lack of familiarity with U.S. tastes, customs and mores. As a result, a product that might sell well in one country may be a total catastrophe in the United States—and vice versa. A classic example is peanut butter, a purely American product. It is frequently as unpopular abroad as it is popular here in the U.S. with the result that an attempt to export peanut butter runs a much higher risk of failure than would exporting other American products.

The foreign business that wishes to expand its market to the United States has a different set of considerations than does the foreign investor who merely wants to invest in a business in the United States. Real estate development is a common example; the successful developer in his home country who wants to come to the United States to become a developer finds when he gets here an entirely different set of laws and procedures than he is used to. To become established, he frequently turns to a U.S. partner under an arrangement whereby the foreigner supplies the money

and the U.S. partner supplies the knowledge and expertise. Although this formula can be a very successful for the foreign investor, it much too often ends in disaster because the partner he chooses is the wrong person for the role. The American may be wrong because he is not experienced in real estate, he does not know how to run a real estate business or, all too frequently, he is simply a fraud. The result is that the foreigner may well lose a significant portion of his investment, become bitter about Americans in general and wind up in expensive and long lasting litigation. The foreign investor most carefully survey his options and weigh numerous considerations.

C. Tax Considerations

1. *Non-Income Tax Considerations*. As with the American going abroad, the foreign investor coming to the United States should consider the various taxes which he will face in his operation. The list is no different than the list which is set forth under II(B) (1) above but a special comment about estate tax is appropriate at this juncture.

The Internal Revenue Code has a group of sections which impose a tax on the estate of a nonresident alien. The tax is imposed on all property of the decedent which is situated within the United States.[27] That phrase (property situated within the United States) encompasses all tangible personal property as well as real property located in the United States and both stock in a domestic corporation as well as debt obligations of a United States person including any government or governmental division.[28] The term does not include the proceeds of life insurance or bank deposits.[29]

What all of that means is that if a nonresident alien elects to invest in the United States through a U.S. corporation the shares of which he holds directly, upon his death, he runs the significant risk of having the entire value of those shares included in his estate for U.S. estate tax purposes. The same is true, of course, if he merely invests in the stocks and bonds on the stock market. The relatively simple solution to that problem is to have the foreign investor create a foreign corporation in a tax haven jurisdiction and have that corporation do all of the investing. That step is a relatively inexpensive and simple insurance policy.

2. *Income Tax Considerations*

a. *In general*. Unlike the American taxpayer, two separate income tax schemes are applied to the nonresident taxpayer.

27. I.R.C. § 2103 (1982).
28. I.R.C. § 2104(a) and (b) (1982).
29. I.R.C. § 2105(a) and (b) (1982).

First, income may be classified as "fixed or determinable annual or periodical" (FDAP) income which is subject to a tax of 30 percent (unless a treaty provides for a lower rate) on the gross amount paid. Secondly, income may be classified as "effectively connected" with the taxpayer's conduct of business in the United States which is taxed on the net amount received after deductions at regular rates. Both of those taxing regimes are discussed in the following sections.

b. *FDAP income*. FDAP income is basically passive income consisting of interest, dividends, certain personal services, rents in certain cases, royalties and similar types of income.[30] Perhaps the two most important types to the foreign investor are interest and dividends.

i. *Interest*. The classic definition of interest is that it is the consideration paid for the use or forebearance of the use of money.[31] Interest has grown in attractiveness to the foreign investor not only because it normally represents a return on a rather safe investment but also because terms are flexibly altered simply by adjusting the interest rate and finally because of its tax advantage over an equity investment. Interest permits the diversion to the lender of what might otherwise be considered as investment profit.[32] This circumstance can offer the best of both worlds to the borrower and the lender, since the interest is deductible to the borrower when paid and can be, in certain cases, tax free to the lender when received.

In view of the popularity of interest producing investments with the foreign investor, we have set forth below a short description and commentary on various interest producing investments currently offered.

> —Certificates of Deposit (CDs). CDs are deposits with banks for usually short, specified periods, ranging generally from 30 to 180 days. Their popularity is probably ascribed to the tax-free status of the interest payments coupled with the investment's security and liquidity.
>
> —Bankers Acceptances. Bankers acceptances are negotiable bills of exchange payable in the future and which have been stamped with an acceptance by the bank on which they are drawn. Thus, the bank, in addition to the drawer, is liable on the instrument, making the investment very safe. The document is always a discount instrument. Thus, if the instrument

30. I.R.C. § 871(a)(1)(A) (1982).

31. Deputy v. DuPont, 308 U.S. 488, 497 (1939); Old Colony R.R. Co. v. Comm'r 284 U.S. 552, 560 (1932).

32. *See, e.g.*, Stevens Bros. & Miller-Hutchinson Co. v. Comm'r, 24 T.C. 953 (1955).

is a draft drawn by a U.S. Importer in favor of a Tokyo exporter promising to pay $10,000 in 90 days, then the document can be sold immediately upon receipt by the Tokyo exporter at a discount. The discount represents an interest payment by the seller of the note but the actual source of the payment is in the U.S. when the U.S. Importer pays the note. It is therefore considered to be interest earned in the U.S., even though it is identified as a banker's acceptance. The interest is only exempt from tax, however, if the interest represents original issue discount with a maturity of six months or less. If the due date of the draft is more than six months after the issue date, the interest is not tax exempt (unless an applicable treaty provides otherwise) because the funds used to buy the instrument are not deposited with a person carrying on a banking business.

—U.S. Government Securities. In addition to the myriad of paper issued by various governmental agencies, this category includes the U.S. Treasury issues: Treasury Notes, Treasury Bills and Treasury Bonds.

Treasury Notes are coupon obligations bearing a fixed interest, payable semiannually with an original maturity of one to 10 years. Interest on Treasury Notes, as with most U.S. obligations, is subject to tax and withholding if paid to a nonresident alien ("NRA")

Treasury Bills are discount obligations rather than coupon obligations. Although some run as long as a year, most are of 90 to 180 days duration. They are issued in large denominations and are normally free of withholding tax. The reason, as described below, is that original issue discount on paper maturing within six months is simply not subject to tax when in the hands of the NRA.

Treasury Bonds are coupon obligations. They are basically the same as Treasury Notes but have longer maturities.

—Commercial Paper. In order to raise funds on a short term basis, major corporations will frequently issue promissory notes termed "commercial paper." Maturities vary but almost always are less than a year, frequently running about 60 days. The paper is issued at a discount and is highly negotiable because it is in bearer form. (The prohibition against bearer instruments established by the Tax Equity and Fiscal Responsibility Act of 1982 applies only to instruments maturing in more than a year from the date of issue[33] and backed by a bank letter of credit or other guarantee instrument.) If purchased by a nonresident alien or foreign corporation, the tax result turns on the maturity. If less than six months, then the instrument is tax free in the alien's hands (since the interest is original issue discount); if the maturity is longer, then tax is due.

—Repurchase Agreements. Repurchase agreements or

33. I.R.C. § 163(f)(2)(A)(iii) (1982).

"repos" as they are known in the trade are technically sales (usually by a bank) of government securities or other credit worthy paper with a covenant made by the seller to repurchase the paper at a higher price after a specified period of time. The difference between the price at which the bank initially sells the note and the repurchase price equates to interest. The tax result is affected by whether the transaction is viewed as a purchase and resale by the foreign investor or simply a loan of funds. If it is a purchase and resale the gain is free of federal tax because the transaction is treated as a capital transaction.[34]

The better view is that the payment is interest and the transaction, therefore, a loan.[35] Being interest, the issue is whether it is paid as a result of a deposit with a person carrying on a banking business. As discussed below, if interest is paid as a result of a deposit with a person carrying on a banking business, it is exempt from tax. Since the profit realized by the investor is reconstituted as interest, consistency requires that the payment to purchase the repo agreement be treated as a deposit. Hence, if the other party to the agreement is a bank or savings and loan, the interest should be tax free.[36] If not, then the interest is taxable.

—Federal Agency Securities. Various federal agencies issue their own paper and do so with explicit U.S. government support. For example, the Federal Housing Administration ("FHA"), the Export-Import Bank ("Ex-Im Bank"), the Government National Mortgage Administration ("GNMA" or "Ginnie Mae"), the Tennessee Valley Authority ("TVA") issue debt instruments fully guaranteed by the U.S. Government. Other agencies which are privately owned issue paper which the U.S. government is authorized to buy. This paper carries a quasi-governmental flavor. Examples are the Federal National Mortgage Association ("FNMA" or "Fannie Mae"), Federal Home Loan Banks ("FHLB"), Federal Land Banks ("FLB") and others. None of the interest paid on these obligations is free of tax to the nonresident unless the six month original issue discount rule applies.

The basic tax rule is that interest paid by a U.S. person to a foreign payee is subject to tax at the rate of 30 percent (normally withheld by the payor).[37] A uniquely important exception to this rule is that interest paid to nonresident aliens or foreign corporations on deposits with banks or savings and loans is exempt from income tax.[38] Time certificates of deposit, open account time deposits and multiple maturity time deposits are all "deposits"

34. Citizen's Nat'l Bank of Waco v. United States, 551 F.2d 832 (Ct. Cl. 1977).

35. Rev. Rul. 74-27, 1974-1 C.B. 24; *see also*, Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), *cert. denied*, 400 U.S. 827 (1970); Ltr. Ruls. 7939041 and 7946094.

36. Rev. Rul. 74-24, 1974-1 C.B. 24; *see also*, Pvt. Ltr. Ruls. 79-39041, and 79-46094.

37. I.R.C. § 871(a)(1) (1982).

38. I.R.C. § 861(a)(1)(A) (1982).

within this rule.[39] Virtually all other interest is subject to tax unless a treaty provides to the contrary (e.g., the treaty between the United States and the Netherlands).

Bearing in mind that the United States only taxes FDAP income from sources within the United States, the foreign investor is often surprised to learn that interest paid by a *foreign* corporation can be treated as U.S. source income and hence subject to tax. If the foreign corporation generates more than 50 percent of its gross income from its U.S. business, then the interest paid to a foreign payee is taxed.[40] Thus, if the foreigner invests in a U.S. business or U.S. real estate which is classified as a business through a foreign corporation and that is the sole business of the foreign corporation, the interest which the corporation pays to the foreign lender is subject to withholding tax.

The basic rule of sourcing interest payments is that the source of the interest is the place where the person obligated to pay the debt resides.[41] The place of payment is not a factor to be considered when determining the source of interest[42] and neither is the place where the interest-bearing obligation is kept relevant,[43] nor the location of the person actually making the payment.[44] As an example of the source rule, if an American corporation operates a branch in Hong Kong which borrows money from a Hong Kong bank the source of the interest paid to the Hong Kong bank is the U.S. and is therefore subject to withholding (unless the 80-20 rule—discussed below—applies).

ii. *Dividends.* Since only U.S. source dividends are subject to the 30 percent tax, the crucial determination which the foreign recipient makes is whether or not the dividends received are from U.S. sources. That determination involves two factors: whether the payor of the dividends is either a domestic corporation or a foreign corporation and the source of the payor corporation's goss income.

If the payor of the dividends is a U.S. corporation the dividend is subject to tax (once again normally by withholding) except in that rare circumstance where the U.S. corporation generates substantially all of its gross income from foreign operations. Thus, to the foreign investor the basic rule is that if he receives dividends from a domestic corporation, the dividends are subject

39. Rev. Rul. 72-104, 1972-1 C.B. 209.
40. I.R.C. § 861(a)(1)(D) (1982).
41. I.R.C. §§ 861(a)(1) and 862(a)(1) (1982).
42. A.C. Monk & Co. v. Comm'r, 10 T.C. 77 (1948).
43. Estate of L.E. McKinnon, 6 B.T.A. 412 (1927).
44. Rev. Rul. 66-32, 1966-1 C.B. 174.

to withholding at 30 percent (or a lessor treaty rate if a treaty applies).

Dividends from foreign corporations present greater opportunities for confusion. If less than 50 percent of the corporation's gross income is from a United States business then none of the dividend is considered to be from sources within the United States. If, however, 50 percent or more of the corporation's gross income is effectively connected with the corporation's U.S. business then a portion of the dividend is deemed to be from U.S. sources.[45] The portion of the dividend which is subject to tax is the ratio of the corporation's effectively-connected U.S. business income to the total gross income of the corporation.

> *Example*. Rhoco Corporation, a New York corporation, formed and owned on January 1, 1977 by a Hong Kong citizen declares a dividend on December 31, 1980. During the three years immediately preceding the year in which the dividend was declared (1977, 1978 and 1979), Rhoco earned $80,000 from sources within the United States and $120,000 from sources outside the United States. Since substantially more than 20 percent of Rhoco's gross income was from sources within the United States, then the full amount of the dividend is deemed to be from U.S. sources because Rhoco is a domestic corporation. If, however, Rhoco were a foreign corporation, no part of the dividend would be treated as being from U.S. sources since less than 50 percent of Rhoco's gross income for the base period was from U.S. sources.

iii. *Other types of income.* As indicated other types of income are treated as FDAP income. They include certain types of personal service income, rents and royalties from non-business operations as well as other types of income which may not even be identified in the statute such as alimony payments and certain court judgments. Indeed, even though the acronym "FDAP" means "fixed or determinable annual or periodical" it is well settled that an item of income need not possess any of these qualities in order to be classified as FDAP income.[46]

c. *Capital gain and other non-business income.* As a general rule a foreign taxpayer is not subject to tax on capital gains. A capital gain for U.S. income tax purposes is simply the gain derived by the taxpayer from the sale of a capital asset. A capital asset is any asset which the taxpayer acquires as an investment; in other words, inventory or other property held for sale to customers would not be classified as a capital asset because it is used in a trade or business. For example, if a foreign taxpayer purchased a

45. I.R.C. § 861(a)(2)(B) (1982).
46. Comm'r v. Wodehouse, 337 U.S. 369, 393 (1949).

parcel of land which he held for a while and then sold, the gain would be treated as capital gain because the asset was basically held for investment. If, however, that same taxpayer purchased the land, subdivided it and sold it lot by lot then the gain derived from the sale would be ordinary income because the lots held by the taxpayer were for sale to customers rather than as an investment.

There are two exceptions to the fundamental rule that a nonresident alien is not subject to capital gains tax on capital gain derived from U.S. sources:

(1) If the foreign individual is physically present in the United States for more than six months in the year in which he receives the capital gain then the gain is subject to 30 percent tax;[47] or

(2) If the asset sold is classified as a United States real property interest[48] then it is subject to tax.

Note that a foreign corporation is only subject to the second exception (relating to a U.S. real property interest) since as a legal abstraction it cannot be physically present anywhere.

What that general rule means is that a foreign investor could either directly or through a foreign corporation invest in securities in the United States on a continuing basis and be exempt from U.S. income tax irrespective of the length of time which he may hold any given investment.

A foreign person who is not engaged in business in the United States is also exempt from U.S. income tax when he realizes income from the sale or other disposition of an asset if the income is not effectively connected with a trade or business in the United States. (The Regulations provide as follows: "[I]ncome derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income."[49]) As an example of that rule in operation, consider a foreign taxpayer who is engaged in business in the United States selling personal property (e.g., appliances) and in year ten sells off his inventory and goes out of business but has remaining a significant number of installment sale contracts which are paid over years 11, 12 and 13. The portion of the payments representing principal on those installment sales contracts are not subject to tax because the taxpayer is not engaged in business in the United States during the year when they are received. The portion of the payments representing interest is, of course, FDAP income and subject to income tax.

47. I.R.C. § 871(a) (1982).
48. I.R.C. § 897 (1982).
49. Treas. Reg. § 1.1441-2(a)(3) (1956).

d. *Effectively connected income.* All income of a foreign taxpayer which is effectively connected with the conduct of a business in the United States during the taxpayer's fiscal year is subject to tax at normal U.S. rates.[50] In the large number of cases the taxpayer will be well aware of his being engaged in business in the United States as well as aware of the amount of income which that activity generates. Periodically, however, an issue may arise on that point. To assist the taxpayer in making the determination concerning effectively connected income the law sets forth two alternative tests, the asset use test[51] and the business activities test.[52] By applying these two tests the taxpayer can usually arrive with a fair degree of accuracy at a reliable determination of whether any item of income is effectively connected with the taxpayer's U.S. business.

Another issue which arises from time to time is whether or not the taxpayer is even engaged in business in the U.S. That question normally arises when the taxpayer has had relatively few contacts with the United States in a commercial transaction. Perhaps the best statement of the general principle involved is found in *International Shoe Co.* v. *Washington*,[53] which, though it addressed the issue of the reach of state jurisdiction over distant defendants, nevertheless articulates the principle relevant to the reach of U.S. taxation of foreigners. The Supreme Court stated:

> [T]o the extent that a corporation exercises the privilege of conducting activities within a state, it enjoys the benefits and protection of the laws of that state. The exercise of that privilege may give rise to obligations . . . .

This statement reflects the position of the international tax cases which have dealt with the issue. The basic fact upon which every holding that the taxpayer is engaged in a business in the U.S. is some definable affirmative act in the U.S.[54] The expectation or intention to engage in a business in the United States is not sufficient to warrant a holding that the taxpayer is thereby engaged in a business.[55] On the other hand,no one kind of activity or single substantial activity is required; a series of relatively inconsequential acts is sufficient to support a finding that the taxpayer is engaged in a business in the United States.[56]

Also an agent may have his activity imputed to the principal

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50. I.R.C. §§ 871(b) and 882 (1983).

51. I.R.C. § 864(c)(2)(A) (1983); Treas. Reg. § 1.864-4(c)(1) (1972).

52. I.R.C. § 864(c)(2)(B) (1983); Treas. Reg. § 1.864-4(c)(3) (1972).

53. 326 U.S. 310, 319 (1945).

54. Linen Thread Co. v. Comm'r, 14 T.C. 725 (1950); Spermacet Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958); *aff'd*, 281 F.2d 646 (6th Cir. 1960).

55. Cannon v. Elk Creek Lumber Co., 8 F.2d 996 (7th Cir. 1925).

56. Berliner Handels-Gesellschaft v. United States, 30 F. Supp. 490 (Ct. Cl. 1939), *cert. denied*, 309 U.S. 670 (1940).

so that even though the foreign taxpayer never sets foot in the United States, his agent may nevertheless cause him to be treated as if he were engaged in business in the U.S.[57] That same rule applies to partnerships with the result that every foreign partner, of a partnership engaged in business in the United States, is deemed to be so engaged in business, whether he is a general or limited partner.[58]

The foreign taxpayer, though, is allowed the same deductions as American taxpayers, to the extent that the deductions are properly allocated to the U.S. source income. The definitive regulations on that point[59] set forth a series of rules which were discussed above in sections II (B) (2) (a) (iii).

e. *Real estate investments.* In December, 1980, Congress passed the Foreign Investors Real Property Tax Act ("FIRPTA")[60] which establishes a number of complex rules setting forth the tax obligations of the foreigner who acquires and then disposes of U.S. real estate.

First, consideration of those areas to which FIRPTA does not apply is appropriate. FIRPTA does not affect the tax rules imposed upon a foreign owner of real estate during the period of his ownership. Thus, if a foreign owner holds real estate which produces rent but which is not a business (e.g., the ownership of a warehouse subject to a long term lease) the rental is treated as FDAP income and subject to 30 percent withholding tax. Since that tax is on gross income (meaning that interest, taxes and depreciation are disregarded), the Internal Revenue Code and most treaties provide the taxpayer with an election to treat the real estate as if it were a business and take deductions.[61] Virtually every well-advised foreign taxpayer owning U.S. real property makes that election when there is any doubt at all that the real estate might not be classified as a U.S. business asset.

As a result, virtually all rental from U.S. real estate owned by foreigners is subject to tax on net income (after deductions), at the normal tax rates. Among the deductions which are allowed is interest paid to the beneficial owner of the property, providing that the owner of record title is a corporation, even if all of the stock of the corporation is owned by the beneficial owner. Thus, a nonresident alien may form a U.S. or foreign corporation, have it buy U.S. real property and (as part of the initial transaction) loan it

57. Helvering v. Boekman, 107 F.2d 388, 389 (2nd Cir. 1939).
58. I.R.C. § 875(1) (1982); Donroy Ltd. v. United States, 301 F.2d 200, 208 (9th Cir. 1962).
59. I.R.C. § 871(d) (1982).
60. I.R.C. §§ 861, 871, 882, 897, 6039C, 6652 (1982).
61. I.R.C. § 871(d) (1982).

funds, which will then generate interest deductions to the corporation. Under current rules, the loan can be structured so that the interest paid is free of U.S. tax.

The taxation of gain from the disposition of real estate is rather straightforward. If a foreigner owns any real estate the gain which he recognizes upon its disposition is subject to tax as if the real estate were effectively connected with a U.S. business being conducted by that foreigner.[62] Technically, the tax is levied on the disposition of a "U.S. real property interest" so the crucial task the foreigner has is identifying when he owns a U.S. real property interest. That phrase includes the stock of a domestic corporation which is a United States real property holding corporation. The result is that if a foreign person owns a foreign corporation, which in turn owns a domestic corporation, which owns nothing but U.S. real estate, then upon the sale of the real estate holding corporation's stock or liquidation of the U.S. corporation, a tax will be due on the gain realized by the foreign corporate shareholder. Although there are any number of variations on that theme the basic result is the same.

When the law was originally enacted, Congress provided a five year window with respect to those treaties which provide for the exemption of tax on the disposition of capital assets (e.g., the treaty between the United States and the Netherlands). That window closes on December 31, 1984.[63] As a result, if a Dutch company owned the shares of stock of a U.S. corporation which the Dutch company sold prior to December 31, 1984, then the profit would be free of U.S. income tax even though the corporation were a U.S. real property holding corporation and its shares were a U.S. real property interest.

3. *Informational Returns*. A foreign investor in the United States is concerned with three different acts that require disclosure of information.

The International Investment Survey Act of 1976[64] requires the Department of Commerce to collect and analyze data relating to foreign investment in the United States. That act is fairly wide reaching. It requires disclosure when certain monetary minimums in the acquisition of the following types of property are met: stock of domestic companies, tangible and intangible personal property, real estate, partnerships and joint ventures.

62. I.R.C. § 897(a) (1982).

63. The Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1125(c)(1), 94 Stat. 2599, 2690-91 (1980).

64. 22 U.S.C. § 3101 (1982).

The Agriculture Foreign Investment Disclosure Act of 1978[65] deals with farm land. Every foreign person owning, buying or selling any interest in agricultural or farm land must file a disclosure report with the Department of Agriculture.

Finally, FIRPTA set forth certain requirements with respect to foreign ownership of U.S. real estate. The applicable forms (Treasury Forms 6659, 6660 and 6661) are to be filed annually. They are designed to disclose to the Internal Revenue Service the identity of the ultimate foreign owner of U.S. real estate as well as the amount of real estate owned. If the foreign owner is reluctant to disclose his ownership and identity then those filings can be avoided if the corporation which owns the real estate files a security interest with the Department of the Treasury. As of March 1984, the initial due date of those returns has not been established.

IV. PACIFIC BASIN COUNTRIES

A. Introduction

This section applies the foregoing rules to various countries within the Pacific Basin. The discussion divides the countries into three groups: those countries with treaties with the United States, those countries that are or are treated as possessions of the United States, and all other countries. Treaty countries include Japan, Korea, Australia, New Zealand and the Philippines; possession countries include Guam, the Northern Marianas, the Marshall Islands, the Federated States of Micronesia, and Palau; the third category includes Vanuatu, Hong Kong and Singapore.

B. Treaty Countries

1. *Introductory Comment*. Before turning to the specific countries which have entered into income tax treaties with the United States, the legal relationship of any given treaty and the Internal Revenue Code should be considered. A treaty reflects the supreme law of the land[66] and consequently takes precedence as a general rule over the Internal Revenue Code. If the terms of the treaty conflict with a provision of the Code then whichever was most recently adopted will control.[67] But note that a statute will override a treaty only if Congress clearly identified its intentions to do so when it enacted the later Code section.[68]

Two sections of the Internal Revenue Code, I.R.C. sections

65. 7 U.S.C. § 3501 (1982).
66. Samann v. Comm'r, 313 F.2d 461 (4th Cir. 1963).
67. Reid v. Covert, 354 U.S. 1, 18 (1956).
68. Cook v. United States, 288 U.S. 102, 120 (1933).

894 and 7852(d), confirm the relationship between the Code and treaties.

The important point to bear in mind, however, is that where the Code provides for withholding interest at 30 percent and an applicable treaty imposes a tax at only 10 percent, then the withholding tax will be at 10 percent, not 30. For that reason, a foreign investor from a treaty country should examine not only the workings of the Internal Revenue Code but also the treaty between his country and the United States. Finally, the following discussion is not designed to be an analysis of any given treaty but rather an overview of several treaties.[69]

2. *Japan*. Japan has a sophisticated internal tax system to accompany its advanced technological society. Its tax regime includes corporation taxes, partnership or business profits taxes, individual taxes, capital taxes, and municipal taxes. The currency of Japan is the Yen.

The present treaty between the United States and Japan entered into force in 1972. The treaty effects a number of changes from the rules discussed above.

a. *Source rules*. The treaty alters the basic source rules. Dividends are treated as income from sources within a contracting state only if paid by a corporation of that contracting state.[70] Thus, if a Japanese parent corporation creates a Japanese subsidiary corporation which operates exclusively in the United States, a dividend by the subsidiary under general rules would be treated as being sourced in the United States, but under the treaty is sourced in Japan. Hence, the dividend would not be subject to withholding as it would be if the subsidiary were a U.S. corporation.

Interest is sourced at the residence of the payor (the same as the general rule) except when the payor has a permanent establishment in the other country and the interest paid is related to any debt borne by the permanent establishment. Also, if the payor is a resident of one of the contracting states but has a permanent establishment in a third country and that permanent establishment incurred the debt and bears the interest then the interest shall be deemed to be from sources within the third country.[71] In other words, if a Japanese corporation had a permanent

69. For an analysis of the Specific treaties, together with a discussion of the various model income tax treaties presently extant, *see* 3 Rhoades and Langer, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS, chs. 9-15 (Matt. Bend. & Co. rev. 1983).

70. Treaty on Income Taxation, Mar. 8, 1971, United States-Japan, art. 6, § 1, 23 U.S.T. 967, 977, T.I.A.S. No. 7365 at 2.

71. *Id.* art. 6, § 2, 23 U.S.T. at 977-78, T.I.A.S. No. 7365 at 11-12.

establishment in the United States and the debt were properly allocable to that permanent establishment, the interest would be deemed to be from U.S. sources not Japanese sources even though the corporation might not be treated as a resident of the United States. In addition, if a Japanese corporation had a permanent establishment in Hong Kong, which incurred the debt, then the interest would be deemed to be from sources in Hong Kong not in Japan.

b. *Business profits.* Business profits (frequently referred to as "industrial or commercial profits") of a taxpayer doing business in a host country are exempt from tax by the host country unless the taxpayer is engaged in business in the host country through a permanent establishment. If he is, then to the extent that the profits are attributable to the permanent establishment, they may be taxed by the host country.[72] That rule is a change from the general rule. What it means is that a Japanese corporation or businessman can engage in business in the United States and, if he is able to do so without using a permanent establishment, his income will be free of U.S. income tax. The rule, however, does not bind the individual states of the U.S. in which he might operate, so that the state may impose tax on the income.[73]

c. *Permanent establishment.* The concept of a permanent establishment is essentially the same throughout the numerous U.S. income tax treaties. A permanent establishment is a fixed place of business through which a resident of a contracting state engages in an industrial or commercial activity.[74] The term includes an office, a factory, a workshop, a warehouse, a mine or other place for extracting natural resources and virtually any other fixed place. It does not include, however, the use of a building or location for the purpose of storing, displaying or delivering goods or merchandise. The phrase "permanent establishment" also does not include the place where a stock of goods or merchandise belinging to the taxpayer is maintained if he does so for the purpose of storage, delivery to or processing by another person.[75] Finally, it does not include the purchase of goods or merchandise, the collection of information, the supply of information, and the conduct of scientific research or similar activities which have a preparatory or auxiliary character for the resident.[76]

Generally the taxpayer will recognize when he has a perma-

72. *Id.*, art. 8, § 1, 23 U.S.T. at 982-83, T.I.A.S. No. 7365 at 16-17.
73. *Id.*, art. 1, § 1(a), 23 U.S.T. at 969, T.I.A.S. No. 7365 at 3.
74. *Id.*, art. 9, § 1, 23 U.S.T. at 984-85, T.I.A.S. No. 7365 at 18-19.
75. *Id.*, art. 9, § 3(b) and (c), 23 U.S.T. at 985-86, T.I.A.S. No. 7365 at 22-23.
76. *Id.*, art. 9, § 3(d) and (e), 23 U.S.T. at 986, T.I.A.S. No. 7365 at 23.

nent establishment but as with all areas of the law there will be times when the question is open and the answer not clear. In those cases the taxpayer can rest assured that the government involved will take the most advantageous position by which to exact tax revenue—usually that means the government will assert there is a permanent establishment.

d. *Dividends*. The general tax rate on dividends set by the treaty is 15 percent.[77] If, however, the payee is a corporation and the payee owns at least 10 percent of the voting shares of the payor corporation and the payor corporation generates substantially all of its gross income from the conduct of a business, then the tax rate is 10 percent. Thus, if a Japanese corporation forms a U.S. subsidiary, which operates a business and pays dividends to its parent corporation, then the withholding rate is 10 percent. That is a significant provision in the law because the net effective tax rate (assuming the subsidiary conducts all of its business in California, for example) on net taxable income earned by a subsidiary may be reduced by five percent if a Japanese corporation is used as the subsidiary rather than a U.S. corporation.[78]

e. *Interest*. Interest is subject to a withholding tax of 10 percent when paid by a payor resident of one of the contracting states to a resident of the other.[79]

f. *Capital gains*. As a general rule, gains derived from the sale of capital assets by a resident of one of the contracting states will be exempt from tax by the other unless the gain falls into certain narrow classifications, one of which is real estate.[80] In other words, if a Japanese corporation owns the shares of stock of a corporation that would be classified as a U.S. real property holding corporation then it may sell those shares of stock free of U.S. income tax notwithstanding FIRPTA, at least until December 31, 1984.

There are a number of other important articles in the treaty, of course, including a non-discrimination provision and an exchange of information provision which are standard to other treaties.

3. *Korea*. Korea is a rapidly industrializing society. Its in-

77. *Id.*, art. 12, § 2(a), 23 U.S.T. at 989, T.I.A.S. No. 7365 at 26.

78. For additional reasons to use a foreign subsidiary to operate in the United States, rather than a U.S. subsidiary, *see* Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176 (1982).

79. Treaty on Income Taxation, United States-Japan, art, 13, § 4, 23 U.S.T. at 990, T.I.A.S. No. 7365 at 27.

80. *Id.*, art. 16, 23 U.S.T. at 994, T.I.A.S. No. 7365 at 31.

creasing importance in the international economy is reflected by the relatively recent advent of a tax treaty with the United States. The first treaty with Korea did not enter into force until 1979. As it becomes a major industrial force its attractiveness to the U.S. businessman likewise grows, especially to those industries that are somewhat labor intensive.

Korea has the usual gamut of taxes including individual taxes, partnership or business taxes, corporation taxes, capital taxes and dividend taxes. Korea also has a restriction on the repatriation of foreign investment. Repatriation is prohibited during the first two years of investment and then is restricted to 20 percent annually thereafter. The Korean government will guarantee repayment of principal and interest on foreign loans needed to finance investments in basic industries, in agriculture, in fishing and certain service industries such as transportation. The Korean government also guarantees foreign investors against expropriation or requisition except in the event of national emergency. All foreign investments in Korea must be registered with the Foreign Examination Council.

The currency of Korea is the Won.

Because the Japanese treaty and the Korean treaty were signed relatively close together in time they are somewhat similar. When appropriate, reference will simply be made back to the comments under the Japanese treaty.

a. *Source rules*. Source rules as to dividends and interest are the same in the Korean treaty as they are in Japanese treaty.[81]

b. *Business profits*. With slight variation, the article relating to business profits in the Korean treaty is the same as it is in the Japanese treaty.[82]

c. *Permanent establishment*. The provisions relating to a determination of the existence of a permanent establishment under the Korean treaty are substantially the same as they are under the Japanese treaty.[83]

d. *Dividends*. The rate of withholding tax on the payment of dividends by a corporation of one contracting state to the resident of another is 15 percent[84] unless the payee is a corpora-

81. Treaty on Income Taxation, June 4, 1976, United States-Korea, art. 6, §§ 1 and 2, 30 U.S.T. 5253, 5267, T.I.A.S. No. 9506 at 15.

82. *Id.*, art. 8, 30 U.S.T. at 5272-75, T.I.A.S. No. 9506 at 20-23.

83. *Id.*, art. 9, 30 U.S.T. at 5275-79, T.I.A.S. No. 9506 at 23-27.

84. *Id.*, art. 12,§ 2, 30 U.S.T. at 5281-82, T.I.A.S. No. 9506 at 30-31.

tion and meets the same 10 percent voting stock standard as is set forth in the Japanese treaty. The same comment relating to the net effective tax rate of a U.S. subsidiary of a Korean enterprise as compared to a Korean subsidiary of a Korean enterprise that was made with respect to the Japanese treaty applies equally.

e. *Interest*. The rate of withholding tax on payment of interest by a payor in one contracting state to a resident of another is 12 percent.[85]

f. *Capital gains*. The provisions relating to capital gains in the treaty with Korea are almost word for word identical to those in the treaty with Japan.[86] Hence, the same comments apply.

4. *Australia.* Australia is a long standing treaty partner with the United States. The present Australia-I treaty was entered into over 30 years ago and thus reflects a number of historic provisions which are different from the more recent treaties. Australia has a sophisticated tax system with fairly high rates. The corporate rate, as the U.S. corporate rate, is 46 percent; the individual tax rate is graduated with a maximum rate of 60 percent. Australia has enacted the usual complement of other taxes.

Australia has an exchange limitation administered by the Exchange Control Board which must approve any requested exchange of Australian dollars for other currency. It also has a statute limiting the ability of foreign persons to acquire Australian businesses. Under the Foreign Takeovers Act of 1975 the government must approve any acquisition by a foreign entity. Approval is not required for new investments with a A$5,000,000 limitation.

As used in the Australian-I treaty, the term, "Australia", includes the territories of Papua, New Guinea and the Norfolk Islands.

The currency of Australia is the Australian dollar.

The following comments relate to the Australia-I treaty. The Australia-II treaty entered into force early in 1984. Since Australia-II is now the prevailing treaty, the following comments are to some degree of historical interest only.

a. *Source rules*. The old treaty did not have a separate article modifying the source of income rules. In certain cases the effect of an article was to modify the source rules by implication.

b. *Business Profits*. Tax was not imposed by a con-

85. *Id.*, art. 13, § 2, 30 U.S.T. at 5282, T.I.A.S. No. 9506 at 31.
86. *Id.*, art. 16, 30 U.S.T. at 5286-87, T.I.A.S. No. 9506 at 35.

tracting state on a business operation unless the taxpayer had a permanent establishment in that state.[87] Unlike the recent treaties, the old Australian treaty had a "force of attraction" provision which means that if the taxpayer had a permanent establishment in the other country then the entire amount of income generated from that country would be "attracted to" the permanent establishment and subject to the taxation by the other country. For example, if an Australian enterprise engaged in two separate operations, one utilizing a permanent establishment and one not, then the income from the non-permanent establishment operation was nevertheless taxable by the United States because the taxpayer had another permanent establishment in the United States.

c. *Permanent establishment*. The definition of "permanent establishment" in the old Australian treaty is much narrower than it is in the other recent treaties. It only included any fixed place of business and merely excluded a fixed place of business used exclusively for the purchase of goods or merchandise and operations through a subsidiary or arms' length independent commission agent.[88]

d. *Dividends*. The rate of tax on dividends paid by a corporation organized in one country to a resident of another was 15 percent.[89]

e. *Interest*. The treaty did not have an article on interest so the general withholding rules of each country applied.

f. *Capital gains*. The treaty did not have an article on capital gains so the general rules discussed above applied.

g. *New treaty*. A proposed new treaty with Australia was signed in August, 1982 and was ratified by the U.S. Senate in August, 1983. It became effective in early 1984. It is substantially similar to the Japanese and Korean treaties. The tax on dividends remains at 15 percent[90] but the tax on interest drops to 10 percent.[91] The treaty has a capital gains provision which will be compatible with FIRPTA.[92] The definition of "Australia" is expanded to include the Christmas Island, the territory of the Co-

87. Treaty on Income Taxation, May 14, 1953, United States-Australia, art. III, §§ 1 and 2, 4 U.S.T. 2274, 2279, T.I.A.S. No. 2880 at 6.

88. *Id.*, art. II, § 0, 4 U.S.T. at 2278, T.I.A.S. No. 2880 at 5.

89. *Id.*, art. VIII, 4 U.S.T. at 2282, T.I.A.S. No. 2880 at 9.

90. Treaty on Income Taxation, Aug. 6, 1982, United States-Australia, art. 10, § 2, 1 TAX TREATIES (CCH) ¶ 402K.

91. *Id.*, art. 11, § 2 at 402L.

92. *Id.*, art. 13, at 402N.

cos (Keeling) Islands, the territory of Ashmore on the Cartier Islands and the territory of the Coral Sea Islands.[93]

5. *New Zealand*. The original treaty with New Zealand was also of the older variety, having been signed in 1948 and entering into force in 1951. A new treaty of the more recent type is now in force. New Zealand's tax system does not appear to be nearly as complex as that of many other U.S. treaty partners. It does have the basic corporation tax; the rate applicable to resident companies is 45 percent on world-wide income and the rate on nonresident companies is 50 percent on New Zealand source income. The tax to individuals is a graduated tax with the maximum rate at 60 percent. New Zealand has the usual other taxes such as a capital tax and a dividend tax. Although there is no remittance tax in New Zealand, any amounts transferred out of the country must be approved by the Reserve Bank of New Zealand.

"New Zealand," as used in the original treaty, included all islands and territories within the limits of New Zealand and the Cook Islands. That treaty remained in effect as to the Cook Islands even though they achieved self-governing status in association with New Zealand in 1965. Further, the Cook Islands took steps to become an international finance center with the result that, until the new New Zealand treaty entered into force, the United States investor or businessman found a corporation operating out of the Cook Islands a useful tax planning tool.

The currency is the New Zealand dollar. The following comments relate to the original New Zealand treaty.

a. *Source rules.* As the old Australian treaty, the original New Zealand treaty lacked any definitive rules relating to sourcing.

b. *Business profits.* The rules under the New Zealand treaty were the same as those under the Australia-I treaty with the added provision that New Zealand law with respect to the taxation of income from the insurance business prevailed over the treaty.[94]

c. *Permanent establishment.* The provisions of the original treaty relating to a permanent establishment were substantially similar to those for the Australia-I treaty.[95]

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93. *Id.*, art. 3, § K, at 402D.

94. Treaty on Income Taxation, Mar. 16, 1948, Unites States-New Zealand, art. III, §§ 1 and 2, U.S.T. 2378, 2382, T.I.A.S. No. 2360 at 5.

95. *Id.*, art. II, § 0, 2 U.S.T. at 2381, T.I.A.S. No. 2360 at 4.

d. *Dividends*. The maximum rate of tax applicable to dividends paid by a U.S. corporation to a resident of New Zealand was 15 percent with the additional provision that if the payee was a resident of the other contracting state and owned at least 95 percent of the voting power of the payor corporation (and the payor corporation was engaged in an active business) the rate of tax was reduced to 5 percent.[96]

e. *Interest.* As with the Australian treaty there was no provision in the original New Zealand treaty relating to interest so the general withholding rules of each country applied.

f. *Capital gains*. The New Zealand treaty did not have a provision relating to capital gains.

g. *New Treaty*. A new treaty with New Zealand has been signed and it is now in force. It and its related protocol were ratified by the United States Senate in August, 1983. Under the new treaty the Cook Islands are specifically excluded from coverage.[97] Also, under the new treaty dividends by a corporation of one contracting party to a resident of the other contracting party are set at 15 percent[98] (meaning that the 5 percent rate on dividends paid by subsidiaries will be dropped), and the rate of tax on interest paid by a resident of one contracting state to another is 10 percent.[99] The treaty contains a capital gains provision which reflects and is compatible with the provisions of FIRPTA.[100]

6. *Philippines*. The tax treaty with the Philippines although signed in 1976 did not enter into force until 1982. An investor in the Philippines should be cautious because of the state's potential political instability. Although the Marcos family has been in power for almost two decades its political future is uncertain and it employs less than democratic methods to achieve its ends.

The Philippines has the usual gamut of taxes. The corporation tax rate is 35 percent on worldwide income of a Philippine corporation and 35 percent on income earned in the Philippines on branches of foreign corporations plus a 15 percent withholding tax on remittances made by the branches. The tax rate on individuals is graduated up to a maximum of 35 percent on regular income and 50 percent on individual business income. In addition,

96. *Id.*, art. VI, 2 U.S.T. at 2384, T.I.A.S. No. 2360 at 7.

97. Treaty on Income Taxation, July 23, 1983, United States-New Zealand, art. 3, § 1(h), 2 TAX TREATIES (CCH) ¶5902D.

98. *Id.*, art. 10, § 2, at 5902J.

99. *Id.*, art. 11, § 2, at 5902L.

100. *Id.*, art. 13, at 5802N.

there is a gross receipts tax which can run as high as two percent of gross sales. The amount of remittances made of profits, dividends or capital is unrestricted when exchanged at the free market rate.

The currency of the Philippines is the Peso and is tied to the U.S. dollar at 11.05 Pesos per U.S. dollar.

a. *Source rules*. A dividend is treated as sourced within the country where the corporation paying the dividend is created, except when 50 percent or more of the corporation's gross income is derived from the conduct of a business in another contracting state. In such a case the dividend is allocated much the same as under the general U.S. rules. Thus, a Philippine corporation which creates a Philippine subsidiary to operate wholly in the United States is treated as receiving U.S. source dividends from the subsidiary. Interest is deemed sourced at the residence of the payor unless it is connected with a permanent establishment in another state in which case it is sourced within that state.[101]

b. *Business profits.* The taxation of business profits follows the general rule set forth in the recent treaties such as the Japanese and the Korean treaties.[102]

c. *Permanent establishment.* The definition of permanent establishment is much the same as it is in the recent treaties but is expanded to exclude from the definition the furnishings of services in accordance with an agreement between the states regarding technical cooperation.[103]

d. *Dividends*. Dividends are subject to tax at 25 percent unless the payee owns 10 percent or more of the voting stock of the payor corporation, in which case the rate is 20 percent.[104]

e. *Interest*. The rate of tax on interest paid by one country's resident to another country's resident is 15 percent.[105] However, if the interest is paid on public issue bonded indebtedness the rate is 10 percent.[106] Notwithstanding those provisions, interest is completely exempt from tax if it is paid to an instrumentality of one of the governments or is paid to a resident of one of the contracting states pursuant to a debt obligation guaranteed

101. Treaty on Income Taxation, October 1, 1976, United States-Philippines, art. 4, § 1, 2 TAX TREATIES (CCH) ¶6607.
102. *Id.*, 4, § 2, at 6607.
103. *Id.*, 5, § 3(f), at 6608.
104. *Id.*, 11, § 2, at 6614.
105. *Id.*, 12, § 2, at 6615.
106. *Id.*, 12, § 3, at 6615.

or insured by a government or an instrumentality of one of the contracting states. The result of these curious provisions is that interest paid on a U.S. savings bond to a resident of the Philippines is subject to 25 percent withholding tax but interest paid on an FHA guaranteed mortgage note is free of tax.

f. *Capital gains*. The provisions of the Philippine treaty allow tax free sales of U.S. real shares of U.S. real property holding corporations.[107] The United States Senate ratification of the treaty, however, was conditioned on a modification of that provision (which was accepted by the Philippine government) which includes the provisions of FIRPTA in the treaty.[108]

C. Possession Countries

1. *Introductory Comment*. Of all U.S. possessions, more than half are in the Pacific Basin. Those possessions in the Pacific Basin in addition to Guam include American Samoa (a small island approximately 3,000 miles east of Australia), Johnston Island (a small atoll 1,000 miles west of Hilo, Hawaii), Midway Islands (a group of islands approximately 1,500 miles northwest of Honolulu) and Wake Island (a small island approximately 2400 miles west of Hilo, Hawaii).

This separate section on possession countries is included because other island countries in the Pacific Basin are now treated or shortly will be treated, for tax purposes, as if they were possessions of the United States. The following discussion focuses on the rules applicable to possessions.

For tax purposes a possession of the United States is treated as a foreign country. The term United States for tax purposes includes only the fifty states of the Union and the District of Columbia.[109] Hence, a foreign corporation is any corporation which is created or organized outside of that region.[110] As a result, unless specifically authorized to the contrary in the Internal Revenue Code, possession corporations and citizens of U.S. possessions(who are not otherwise citizens of the United States) are treated as foreign corporations and nonresident aliens, respectively.[111] Further more, a corporation incorporated in a possession but owned by an American is a controlled foreign corporation.

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107. *Id.*, 14, § 2, at 6617.
108. S. RES., 97th Cong., 1st Sess., 127 CONG. REC. 15533.
109. I.R.C. § 7701(a)(9) (1982).
110. I.R.C. § 7701(a)(5) (1982).
111. I.R.C. § 932 (1982).

2. *Tax Rules Uniquely Applicable to Possessions Other Than Guam*. A U.S. citizen or domestic corporation, which derives 80 percent or more of its gross income for a period of three years immediately prior to the close of the taxpayer's taxable year (or, if the taxpayer was not in existence for that period of time, for so much of that time as it was in existence) and generates 50 percent or more of its gross income from the active conduct of a business in a U.S. possession, is allowed to treat as gross income for U.S. income tax purposes only the gross income which is earned from sources within the United States. (I.R.C. §931). In other words, if a U.S. corporation commences operation in the U.S. possession (excluding Guam) and limits its business activities to operating in the U.S. possession, it will only be required to pay tax to the possession and not to the United States. For a limited number of taxpayers this can be a beneficial rule.

All Pacific Basin possessions (including Guam) are entitled to the benefits of the possession tax credit.[112] That credit effectively allows the U.S. taxpayer to derive business income from a possession free of U.S. tax.

3. *Guam*. Guam, an island approximately 1500 miles east of Manila, has two interesting features: (a) finance for the Pacific Basin and (b) the tax system of Guam is virtually the same as that of the United States. Guam has adopted a mirror image of the Internal Revenue Code. Whenever the word "United States" appears in the Internal Revenue Code one should substitute "Guam" and whenever the phrases "domestic", "foreign" and "nonresident alien" appear, they apply to persons and entities from Guam's point of view rather than from that of the United States.[113] The result is, with one exception, that a corporation created in Guam and operating in the United States is treated by the United States Internal Revenue Code as a foreign corporation and under the Guam Internal Revenue Code as a domestic corporation; similarly, a U.S. corporation operating in Guam is treated under the Guam Internal Revenue Code as a foreign corporation and, of course, under the U.S. Internal Revenue Code as a domestic corporation. The one exception to this symmetry is found in U.S. I.R.C. section 881(b) which provides that the term "foreign corporation" does not include a corporation created or organized in Guam or under the law of Guam. Since that exception is limited to FDAP income earned by such a corporation, it is a relatively limited exception but it may prove to be important. The

112. I.R.C. §§ 33 and 936 (1982).

113. *See generally* 48 U.S.C. § 1421i(d)(1) and (e) (Supp. V 1981) for the rules concerning the adoption in Guam of a mirror image of the U.S. Internal Revenue Code.

effect is that if a Guam corporation loans money to a U.S. debtor, the payment of interest on that debt is not subject to withholding because the Guam corporation is not treated as a foreign corporation for purposes of the FDAP provisions. Conversely, if a U.S. corporation loans money to a Guam entity then the payor in Guam need not withhold because the U.S. lender for purposes of Guam law is not treated as a foreign corporation.[114]

In the early 1980s Guam embarked upon a program designed to attract international finance subsidiaries ("IFS's") to Guam. From the U.S. point of view, that program seemed to make a good deal of sense. At the moment the Netherlands Antilles dominates that business with virtually no other jurisdiction offering any competition. The amount of income earned by the Netherlands Antilles cannot be determined with precision but may well approach $90,000,000 annually. Since Guam is a financial burden to the United States, one would expect that this effort by Guam would be supported.

The analysis which follows describes the present status of Guam's effort to be a center for international finance subsidiaries.

Under Guam law the payment of interest to a foreign corporation is subject to withholding tax in favor of Guam, the same as interest paid to a foreign corporation formed in a non-treaty country if paid by a U.S. payor. Under the Guam version of the Internal Revenue Code, however, the 80-20 rule applies. That rule states that if interest is paid by a Guam corporation and less than 20 percent of the gross income from all sources of the paying corporation is derived from within Guam, then the interest shall be treated as coming from sources outside of Guam.[115] Since the funds earned by the Guam IFS from selling its bonds to foreign lenders (the bonds being guaranteed by the U.S. parent corporation) will in turn be lent to its U.S. parent and its U.S. parent's affiliates, the sole source of income of the Guam IFS will be foreign as to Guam. As a result, the Guam IFS will easily meet the 80-20 requirement and its interest payments to the foreign lenders will be free of withholding by Guam.

In addition Guam amended its corporate laws in order to make them more attractive to American parent corporations and obtained the help of Merrill, Lynch to further boost itself as an emerging force in the financial community in the Pacific Basin. That vision was abruptly and, perhaps, improperly terminated, when the Treasury issued temporary regulations attacking

114. *See* Vitco, Inc. v. Gov't of the Virgin Islands, 560 F.2d 180 (3rd Cir. 1977), *cert. denied*, 435 U.S. 980 (1978).

115. I.R.C. § 861(a)(1)(B) (1982).

Guam's status as a center for international finance subsidiaries.[116] The temporary regulations provide that income derived from sources in Guam, the U.S. Virgin Islands or the Northern Marianas that is not subject to tax in the jurisdiction of source is to be treated as income from U.S. sources. If that regulation is upheld the effect will be to treat the income earned by any U.S. corporation in, for example Guam, which is not taxed in Guam as U.S. source income. The adverse effect of that rule on the IFS structure becomes evident when the mirror theory is applied.[117] When the U.S. regulation is applied, the result is that the interest derived from sources within the United States is considered to be from sources in Guam. When the mirror image is applied in Guam, the Guam corporation is not able to take advantage of the 80-20 exception and the interest paid by the Guam corporation's foreign bond holders is subject to Guam withholding tax.

Inquiries to the Department of the Treasury as to why it had adopted regulations which had the effect of preferring the Netherlands Antilles to Guam brought a vague response at best. Further, in response to an inquiry about the statutory basis for the regulation, the answer was equally vague. It was clear to your author, however, that the Treasury Department is well aware of the chilling effect that the proposed regulations are having on Guam's attempts to attract IFS business. Unfortunately, the effect is the same whether the regulations have statutory support or not.

4. *The Northern Mariana Islands.* The Northern Mariana Islands are part of the trust territory of the Pacific Islands (consisting of the Northern Mariana Islands, the Marshall Islands and the Caroline Islands) and though the Marianas are not a possession of the United States, they are treated precisely as Guam is treated.[118] The Covenant establishing this tax relationship specifically excludes the Marshall Islands and the Caroline Islands from its coverage. As with Guam, the U.S. Internal Revenue Code is the governing legislation in the Northern Mariana Islands.

5. *Palau, the Marshall Islands and the Federated States of Micronesia.* The island countries of Palau, the Marshall Islands and the Federated State of Micronesia are all included in the trust territory of the Pacific Islands and are located in an approximate 2,500 mile arc running east of Mendinao in the Philippines. These

116. See Temp. Treas. Reg. § 4a.861-1(a); *see also* Prop. Treas. Reg. § 1.861-3(a)(2)(ii), 1983-1 C.B. 1065.

117. Vitco, Inc., 560 F.2d at 183.

118. Covenant to Establish a Commonwealth of the Northern Mariana Islands and Political Union with the United States, Pub. L. No. 94-241, 601(a), 90 Stat. 265, 269 (1976), *reprinted in*, 1976-1 C.B. 513.

nations are included in this section because the United States and each of those countries (in August, 1982 as to Palau, October, 1982 as to Micronesia, and June, 1983 as to the Marshall Islands), have signed the "Compact of Free Association"[119] (hereinafter "the Compact"). Section 255 of the Compact provides as follows:

> Where not otherwise manifestly inconsistent with the intent of this Compact, provisions in the United States Internal Revenue Code that are applicable to possessions of the United States as of January 1, 1980 shall be treated as applying to Palau, the Marshall Islands and the Federated States of Micronesia. If such provisions of the Internal Revenue Code are amended, modified or repealed after that date, such provisions shall continue in effect as to Palau, the Marshall Islands and the Federated States of Micronesia for a period of two years during which time the Government of the United States and the Governments of Palau, the Marshall Islands and the Federated States of Micronesia shall negotiate an agreement which shall provide benefits substantively equivalent to those which obtained under such provisions.

If the Treasury fulfills the intention of section 255 each of these islands will be treated as a tax possession of the United States with consequent tax advantages to any U.S. corporation which may elect to operate therein. Prior to this occurring, however, the Compact will have to become U.S. law (by act of Congress) and, in all probability, the Treasury will have to issue a revenue procedure or at the very least a revenue ruling implementing the broad terms of section 255.

Until that time, each of those island governments is considered a foreign country under the U.S. tax regime.

D. Other Pacific Basin Countries

1. *Introductory Comment.* Although the following discussion focuses primarily on the internal structure of Hong Kong, Singapore and Vanuatu, the U.S. investor should bear in mind that the discussion relating to outbound transfers applies particularly to these three countries because they do not have any treaty relationship with the United States. Thus, interest paid to a Hong Kong or Singapore bank is subject to 30 percent withholding tax if paid by a U.S. payor; a corporation formed in any of the jurisdictions discussed by a U.S. person will in all probability be a controlled foreign corporation so that the foreign tax credit rules apply and so forth.

2. *Hong Kong.* Hong Kong is probably recognized as the merchant capital of the Pacific Basin. Its position has been

119. As of Feb. 1, 1984 the Compact of Free Association remained in draft form.

shaken, however, by the announcement of the People's Republic of China of its wish to exercise sovereignty over Hong Kong and the appearance that the Thatcher government may well agree to that request. Even with the difficulties that have arisen from these political reverberations, the claim by its residents that Hong Kong is still the seat of commerce for the Far East is a difficult one to refute.

The Hong Kong currency is the Hong Kong dollar. The corporate tax rate on Hong Kong sourced earnings is 16.5 percent, but dividends may be issued free of tax. Hong Kong is attractive to the Chinese entrepreneur because commerce is relatively unregulated and it is politically stable. Its communication and transportation facilities are excellent and most Chinese businessmen speak Chinese and English.

The formation of a Hong Kong corporation is relatively simple and the requirements for its continued administration in Hong Kong are equally simple. There are few restrictions either financial or legal on the formation of a Hong Kong corporation and since income tax is imposed only on income from sources within Hong Kong, a Hong Kong corporation is frequently used for tax haven activities. For example, if an American businessman wished to operate as a middleman (that is, buying from one company and selling to another) the earnings of the Hong Kong corporation would be free of U.S. and Hong Kong tax provided the transaction occurred outside of both jurisdiction.

3. *Singapore*. Only Singapore can successfully challenge Hong Kong in Southeast Asia for its supremacy as a commercial center. It is located at the foot of the Malay Peninsula on the Equator. Its weather, though, is not as agreeable as Hong Kong's. The weather and the Singapore tax structure are its only drawbacks. Although the corporate tax rate is 40 percent in Singapore, the government provides a number of income tax exemptions which frequently reduce that effective tax rate to zero for a period of time. Further, Singapore offers tax avoidance to nonresident companies and to nonresident employees when certain conditions are fulfilled. For example, a company that is nonresident to Singapore is exempt from Singapore income and dividend tax when the following conditions are met: none of the income is sourced in Singapore, the company does not conduct business in Singapore, it does not remit its income to Singapore and it is not managed or controlled in Singapore.

Singapore enjoys both economic and political stability that is the envy of most third world countries. Its communication connection with the rest of the world is excellent; it has one of the largest ports for handling cargo in the world and a marvelous in-

ternal transportation system as well as one of the finest airlines in the world.

Because it has such a large and sophisticated banking system it has attracted and continues to attract large amounts of Asian currency and other deposits. The local currency is the Singapore dollar.

English is the primary language of business and government, although many of the more common Oriental languages are also spoken throughout the area.

The creation of a Singapore company is quick and efficient, inexpensive and free of burdensome regulations.

Although Singapore does not have a tax treaty with the United States, Singapore has entered into treaties with Australia, Belgium, Canada, Denmark, France, West Germany, Israel, Italy, Japan, Korea, Malaysia, Netherlands, New Zealand, Norway, Philippines, Sri Lanka, Sweden, Switzerland, Taiwan, Thailand and the United Kingdom.

4. *Vanuatu (New Hebridies).* Vanuatu is included in this list of other Pacific Island countries because it was so well known as a tax haven when it existed as the New Hebridies. After its independence in July, 1980, and the rebellion of some of the islands forming a new nation, the foreign investor has necessarily become cautious. Vanuatu is growing as a ship registry state and as time passes with relative stability present in the islands, overall confidence in the country appears to be growing.

Vanuatu remains free of internal income tax, although there are the usual governmental fees for the creation and operation of a Vanuatu corporation.

In addition to ship registration Vanuatu has legislation allowing the creation of both captive banks and captive insurance companies at a relatively low cost both in their formation and operation.

Vanuatu's monetary unit is the Vatu.