U.S. Tax Aspects of Operating Abroad: An Overview

Rufus v. Rhoades*

I. Introduction

As most of you who read articles in law reviews and journals have observed, the traditional manner of writing such articles or papers is to base the articles on a thesis which the author either proves, disproves or uses as the foundation for additional theses. This paper breaks with that tradition for a number of reasons. One, by its very nature the paper is a general overview. It does not take a particular subsection of the Code or narrow issue and explore it in depth. Two, there is an extraordinary number of articles, books and other publications that deal with any number of subsections and narrow issues. Three, this symposium, through the auspices of which this paper is presented, was structured as a fundamental symposium rather than a highly sophisticated one.

Consequently, the approach which has been adopted in this article is the problem approach rather than the thesis approach. By "problem approach" we mean that the ensuing discussion of the law will be framed in the context of a hypothetical set of facts designed to allow analysis of the more important sections of the Internal Revenue Code which the advisor who delves into the foreign area must consider. The article does not purport to be an exhaustive review of applicable law, but rather is designed to offer one writer's approach to a rather garden-variety foreign transaction.

The subject matter of the paper is investment by U.S. residents or U.S. corporations abroad. That means the paper was initially limited to a review of the five tentacles of what one practitioner refers to as the foreign tax pentapus.[1] Those five, affecting controlled foreign corporations,[2] foreign personal holding companies,[3] personal holding companies,[4] foreign investment companies[5] and those sections taxing accumulated earnings[6] are not going to be discussed in full in this paper. Rather, the paper will focus on those sections which the advisor will probably need to understand in order to guide his U.S. client as he moves and operates overseas.

---

*Caldwell & Toms, Los Angeles; A. B., San Jose State College; LL.B., Stanford University; Author of Income Taxation of Foreign Related Transactions.

1. That marvelous word is attributed to Harvey P. Dale, Esq. of the New York Bar.

2. Int. Rev. Code of 1954 § 951, *et seq.* [hereinafter cited as Code].

3. Code § 551, *et seq.*

4. Code § 541, *et seq.*

5. Code § 1246.

6. Code § 531 *et seq.*

In view of the inherent limitations of an overview of the kind requested, the paper will not concern itself with (a) foreign trusts, (b) those tentacles of Mr. Dale's pentapus other than controlled foreign corporations or (c) problems of foreign persons who invest in the United States.

II. DEVELOPMENT OF THE HYPOTHETICAL PROBLEM

A. *Statement of the Facts*

The client is referred to you for income tax advice by another lawyer. An appointment is set for the following week. Over the telephone, the referring lawyer briefly describes the transaction about which your advice is sought.

The client, Washco Products, Inc., is a publicly held (incorporated in Delaware) manufacturer of washers and other plumbing products. Although predominantly a U.S. oriented company, Washco has found an increasing demand for its products in Europe. The factor which precipitates your appointment, however, is that Washco has developed a new washer, a key ingredient of which is celidicite, a substance found only in the hills of northern Brazil. Because celidicite is found only in abundance in Brazil and demand for the substance is low, Washco has estimated that it can manufacture high quality washers for one-fifth of the cost of similar quality washers.

In the ensuing conference, it appears that Washco's executives have concluded that the time is ripe for a major expansion overseas. Specifically, Washco has decided to establish a washer manufacturing facility in southern Venezuela (a more practical site for that type of operation than one located in Brazil) and distribution facilities in Europe (the specific sites not yet having been determined). The European facilities are designed to be merely warehouse operations although since Washco does not manufacture a full line of plumbing products, management has decided to allow the European facilities to distribute all types of plumbing products (even those competing with Washco products) throughout Europe.

After your new client leaves your office, you have the job of breaking that proposed plan of action into identifiable, and hopefully, solvable tax problems. The remainder of this paper attempts to walk through one writer's analysis of those problems.

B. *Identification of the Applicable Sections and Treaties*

One of the first steps which one might take in beginning to work with a complex, unfamiliar problem is to identify those sub-areas that are *not* involved. In quickly reviewing the various sections that might be applicable to Washco's proposed course of action, one notes that a substantial number of sections dealing with foreign matters are

not relevant, although a significant number are. Those sections that are not, in all likelihood, going to be relevant are:

Sections	*Content and Reasons for Conclusion*
531-36	*Accumulated earnings.* Wascho, being public, will not be faced with the problem.[7] The foreign aspects of the problem should have little impact on that conclusion.
541-47	*Personal holding company rules.* Washco does not meet the shareholder requirements of five or less individual shareholders owning 50 percent or more of the value of the outstanding stock of Washco.
551-58	*Foreign personal holding company sections.* Again, Washco, does not meet shareholder standards. Note, however, that if any foreign subsidiary of Washco generates foreign personal holding company income, it will thereby generate Subpart F income.[8]
861-89	*Foreign Investors Tax Act.* Those sections deal with the taxation of non-resident aliens and foreign corporations by the United States.
931-935	*U.S. Possessions sections.* It is unlikely that the operations of Washco will lend themselves to being conducted in Puerto Rico, Guam, the Virgin Islands or another U.S. possession.
1246-47	*Foreign investment company.* Washco is not planning on having a foreign subsidiary that is either registered under the Investment Company Act of 1940 or one that is going to engage in the business of investing or trading in securities as defined in that Act.

Having determined which sections are probably not relevant, counsel is now faced with the more difficult determination of which sections are relevant. Before proceeding to a review of those sections,

7. BITKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 8.02, at 8-5 (w, g & l 1971); *cf.* Golconda Mining Corporation, 58 T.C. 139, 157-58 (1972).

8. CODE § 954 (a)(1).

a word of caution. All foreign problems involving foreign revenue and taxation of that revenue by the U.S. have the effect of adding an additional layer of complexity to your standard complex tax problem. In other words, the foreign-related sections of the Code grow out of and are grounded upon the more broadly applicable sections of the Code found in subchapter C and other subchapters. Hence, the sections that are cited below are ones the counselor should consider in addition to those he would consider if the problems were domestic.

The foreign-related sections which may well be relevant and must at least be considered are as follows:[9]

Section	*Substance and Comments*
367	*Recognition of gain in what are otherwise tax free corporate reorganizations.* That section is particularly meaningful to Washco because the transfer of know-how, trade secrets, patents and the like may well involve a recognition of gain if a favorable ruling is not first obtained.
482	*Reallocation of income and deductions.* If Washco sells products to a subsidiary then the price must be an arm's length price or some reallocation of income is likely.
901-907	*Foreign tax credit.* Whether Washco operates through a branch or a foreign subsidiary overseas, it will be concerned with the applicability of the foreign tax credit sections. Those sections are discussed below.
911	*Exclusion of income by U.S. citizens overseas.* The chances are that Washco will send one or more of its executives and quite a few of its staff overseas to operate the foreign operations. The $20,000 (or $25,000 in later years) exclusion provision will be applicable to these employees.[10]
921	*Western Hemisphere Trade Corporation.*

9. The sections are set forth in numerical order as they appear in the Code, not in order of probable importance nor in the order in which, perhaps, they should be studied.

10. As a word of caution, it is not unlikely that section 911 will be either repealed or materially modified by Congress in 1975.

	Because Washco has decided to open operations in the Western Hemisphere, the counselor must at least consider whether the benefits of that section are worthwhile.[11]
951-964	*Subpart F.* Subpart F is the most important group of sections to Washco if it forms a foreign subsidiary. Those sections are discussed in some depth below.
991-997	*DISC.* The domestic international sales corporation sections certainly must be considered since Washco is going to be exporting property.
1248	*Dividend treatment upon disposition of certain foreign corporation's shares.* A part, conceptually, of the Subpart F provisions.
Treaties	Although not a code section, any analysis of Washco's position must be viewed in the light of the applicable income tax treaty between the United States and most developed countries.
Foreign Laws	Finally, since Washco is planning to operate in various foreign countries, the counselor must weigh the possible impact of foreign laws on his plans. Generally, that consideration will require advice of local counsel.

III. CREATION OF THE OVERSEAS CORPORATE STRUCTURE

A. *How to Approach the Problem*

Analyzing almost any complex tax problem requires breaking the problem down into its basic parts and dealing with each individually. Frequently, however, it is appropriate to establish a format in which each of the issues can be analyzed and decisions made. In the problem put on your desk by your client, the easiest analysis is, surprisingly, a geographical one. The problems which the operation in Brazil raises, for example, are different than those which the Venezuelan

11. The Western Hemisphere provisions contained in section 921 are also likely to be repealed or phased out by this Congress. Those provisions are reviewed in some depth in Professor Gifford's article contained in this issue.

and European operations raise. Consequently, this overall problem is probably most easily approached on a geographical basis.

B. *Creation of Operations in Brazil*

1. *Review of Those Facts Relating to the Brazilian Operation.*

A short review of the facts and proposals of the client indicates that Washco is going to obtain rights to the celidicite in Brazil. A basic issue is the type of operation which your client plans to conduct in Brazil. The answer to the structuring problem may well turn on whether Washco simply has the right to buy production or has an interest in the celidicite in place.

2. *Identifying the Alternatives and Issues.*

The issues which you must resolve are: whether the operation in Brazil and Venezuela should be joined or separated; whether the operation in either or both countries should be through a subsidiary or a division; if the operation is to be through a subsidiary, whether the subsidiary should be a U.S. corporation or a foreign corporation; if foreign, whether the country of incorporation should be Brazil, Venezuela (or both) or another country in the nature of a tax haven. Additional issues involve pricing problems. If the Brazilian operation is separately incorporated from the Venezuelan manufacturing facility, the determination of the price of the extracted celidicite sold to the Venezuelan subsidiary must be an arm's length price.

Having begun to identify the issues, you are now able to deal with each one and to begin to weave the fabric of the ultimate corporate structure.

3. *The Selection Process.*

In terms of corporate simplicity, operation through a division is less complex than operating through a subsidiary. Hence, the election to operate in Brazil through a division has at least that advantage. Prior to exploring the other advantages and reviewing the disadvantages, a factual issue followed, perhaps, by a local law problem must be resolved. If the arrangement in Brazil is that Washco has simply agreed to purchase the production (or some part of the production) of an unrelated company engaged in the mining of celidicite, the only issues are whether Brazil will impede exportation of celidicite or require an export license of some kind. In that situation, the issue whether to operate in Brazil through a division or a subsidiary is virtually academic since the only operation being undertaken in Brazil is the purchase of raw materials.

If, on the other hand, Washco has obtained rights to mine, extract and export the raw material in Brazil, local law becomes much

more important. A number of countries have restrictive laws on the extent to which foreign persons are authorized to own minerals or other resources in place. If Brazil has such laws and they are applicable to your problem, the division or subsidiary problem may be answered in that Washco may be required to allow some Brazilian partners to own a part of the mining operation, in which case the only workable arrangement will most likely turn out to be a corporation, owned partly by Brazilians and partly by Washco.

In order to avoid the complexity introduced into the problem by the local law issue, we are assuming for the remainder of the problem that (a) Washco has acquired the rights to mine celidicite for a substantial period of time and (b) there are no restrictions on Washco's ownership of those rights. Additionally, Washco is planning on establishing a significant operation in Brazil to mine, purify, package and export the celidicite to the Venezuelan operation.

The issue of operating in Brazil as a division or a subsidiary remains. In order to deal with that problem we have also assumed that Washco (either through a division or a subsidiary) will sell the celidicite to a wholly-owned subsidiary operating in Venezuela.[12]

4. *Operations in Brazil Through a Division.*

If Washco operates through a division in Brazil extracting and ultimately selling the celidicite, the operation will have immediate U.S. income tax consequences much the same as if the operation were being conducted in the United States. There are a number of sections with which you and Washco must be concerned, however.

First, determination of the impact of the operation in Brazil on Washco's gross income has to be made. Whatever income is earned by Washco's Brazilian division is added to Washco's gross income from all other sources.[13] The basic problem, of course, is the application of applicable allowances, deductions and credits.

On the issue of allowances, subchapter I "Natural Resources" is operative world-wide. Consequently, if Washco would be entitled to a depletion allowance were it mining celidicite in the United States, it will not be precluded from taking advantage of that provision of

12. That assumption is needed in order to focus on the issue of income sourced in Brazil. If the two operations in Brazil and Venezuela are operated as divisions of Washco, then, unless it operates world-wide as a single corporate entity (which is highly unlikely) a sale of the celidicite must occur at some point in the production-distribution operation. A sale at the basic level is simply easier to deal with than is a later sale.

13. Section 61 states that gross income includes "all income from whatever source derived." Foreign source income is, with a few exceptions, not treated differently from U.S. income in terms of its recognition.

the Code merely because the property is located outside of the United States.[14]

Similarly, deductions which reflect expenses incurred in Brazil are allowed as deductions against the gross income of Washco. Thus, if the operation in Brazil generates a new loss, that loss may be used to reduce Washco's income from other sources.[15]

Indeed, the only significant variation to be considered by Washco in calculating its taxable income which includes a foreign branch is the foreign tax credit.[16]

a. The Foreign Tax Credit Available on Income Earned by a Foreign Division of a U.S. Corporation.

The foreign tax credit provisions of the Code are set forth in sections 901-907. The basic section, 901, provides that, if the taxpayer so elects:

> the tax imposed by this chapter[17] shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b). . . .

Under subsection (b), certain amounts are allowed as a credit:

> (1) In the case of a citizen of the United States and of a domestic corporation, the amount of any income . . . taxes paid or accrued during the taxable year to any foreign country. . .;

Thus, subject to the limitation contained in section 904, all of the

---

14. Under Treas. Reg. § 1.611-2, (1960) relating to depletion calculation, the taxpayer is instructed to file certain forms to claim the depletion allowance on foreign minerals. See also Treas. Reg. § 1.613-2(a)(3)(1960).

15. There is no express section of the Code that authorizes foreign as opposed to domestic deductions. The inter-operation of Code Sections 61 (defining "gross income"), 62 (defining "adjusted gross income"), 162 (trade or business expenses) and 901 (foreign tax credit) require the U.S. taxpayer to take into income worldwide gross income less worldwide deductions. *See* proposed Regulation 1.861-8 for an indication of how deductions are to be allocated in certain cases.

16. As so often occurs in an overview of a complex set of rules and procedures, the statement in the text is an oversimplification. One of the most confused areas of the law that comes into play when the U.S. taxpayer begins operations overseas is the calculation of gain or loss from foreign currency transactions. In view of the highly uncertain state of the law and the summary nature of this article, the foreign currency problems have been disregarded. They do exist, however, and must be considered by counsel before final determinations can be made when those determinations turn on calculation of gain or loss from operations. For an exhaustive work on the subject, see A. RAVENSCROFT, TAXATION AND FOREIGN CURRENCY: THE INCOME TAX CONSEQUENCES OF FOREIGN EXCHANGE RATE FLUCTUATIONS (1973).

17. The phrase "this chapter" in section 901 refers to sections 1-1388 of the Code, being the income tax sections contained in Subtitle A, exclusive of tax on self employment income, withholding on nonresident aliens and foreign corporations and certain other provisions.

income taxes which Washco pays to Brazil on its Brazilian income are a direct credit on the income tax payable to the United States. Since the income tax in Brazil is high,[18] the authorization to credit the taxes paid to Brazil rather than being required to merely deduct them is a meaningful part of the decision about the form of entity that is to operate in Brazil.

To the extent, then, that the credit is limited—that is, to the extent the tax paid to Brazil cannot be credited against U.S. tax—the value of the tax credit provisions is obviously restricted. Section 904 creates a limitation on the amount of foreign taxes paid that may be treated as a credit against U.S. income taxes.

Briefly, the section provides that the foreign tax credit for any year is not to exceed a maximum amount. That maximum figure is calculated for each year by the taxpayer. The concept behind the maximum credit which a taxpayer may claim is that the foreign tax credit for any year should not be greater than the United States tax on the foreign income which generated the foreign tax.

Section 904(a)(1) reads as follows:[19]

(a) ALTERNATIVE LIMITATIONS.

> (1) PER-COUNTRY LIMITATION. In the case of any taxpayer who does not elect the limitation provided by paragraph (2), the amount of the credit in respect of the tax paid or accrued to any foreign country or possession of the United States shall not exceed the same proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

Application of the section 904 rules to the facts of any situation can be accomplished by focusing on a few concepts that have been developed from the Code section and regulations.

(1) In order to determine the per-country limitation, multiply

---

18. Thirty percent plus a five percent addition in certain cases. DIAMOND, FOREIGN TAX AND TRADE BRIEFS-SOUTH AMERICA 34 (1975). Although that stated rate is not considered high, when it is combined with Brazil's current runaway inflation, the net effective rate is quite high.

19. Section 904(a) offers the taxpayer an election. He may elect to calculate the foreign tax credit on a "per-country" basis or on an "overall basis." If no election is made, then the per-country rules operate. That means, as a practical matter, the taxpayer has the election to calculate the foreign tax credit limitation on the overall basis rather than the per-country basis. This article is not going to discuss the overall election but will assume that Washco has decided to remain with the per-country limitation. For a further discussion of the overall limitation see 2 R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTION § 5.04(3) (rev. ed. 1975). [hereinafter cited as 2 RHOADES].

the total U.S. income tax for the year by a fraction. The numerator of that fraction is the taxable income from sources within the taxing foreign country (Brazil as to Washco) and the denominator of which is total taxable income from all sources.

> Example: Washco generates $10 million of taxable income in Brazil and has overall $200 million of taxable income. The Brazilian tax on the $10 million is $5 million; the U.S. tax (before credit) on the $200 million is $96 million. The tax credit formula works as follows:
> 96 x 10/200 = 4.8 million

The maximum tax credit which Washco can take for that year is $4.8 million—not $5 million.[20]

(2) The allowable foreign tax credit for taxes paid will always be the lesser of any one of the following three amounts: (a) the amount of U.S. tax against which the credit can be taken; (b) the amount resulting from application of the limitation formula; or (c) the amount of the foreign tax paid or accrued.

(3) The income figures that are used in the fraction are the net taxable income figures from the foreign country and the United States. That usually means that the taxpayer is required to allocate deductions and expenses in order to determine the proper amount of taxable income from foreign and other sources.[21]

(4) The U.S. tax against which the fraction is multiplied to obtain the foreign tax credit limitation is the U.S. tax *before* any other credits are taken.

(5) If the per-country limitation figure is lower than the amount of creditable tax paid or accrued to the foreign country, the amount in excess of the limitation cannot be used as a tax credit that year.

(6) Awareness of the effective tax rates of the countries involved will allow the practitioner to quickly estimate whether or not all creditable foreign taxes will be available as a credit that year.

(7) Losses in one foreign country will have comparatively little effect on the available tax credit flowing from another foreign country when the taxpayer operates in both countries.

(8) If the losses from foreign or domestic operations (or both) result in a total taxable income figure of less than the taxable income from a country where the taxpayer earned a profit, the amount of income deemed received from that country is equal to the taxpayer's total taxable income.

---

20. Section 904(d) provides for a foreign tax credit carry-over and carry back, the effect of which is to allow the taxpayer to average his foreign tax credits over a number of years.

21. A discussion of the method of allocating deductions and expenses follows these rules.

Those rules have been in operation for a substantial period of time. Under them an accepted practice of calculating the available foreign tax credit has evolved which until mid-1973 was at least workable. In June of 1973, however, the Treasury withdrew its longstanding proposed regulations under section 861[22] and substituted new proposed regulations dealing with allocation of deductions. Although the regulations are set forth under a section that is not material to Washco's world-wide operations, the Notice of Proposed Rule Making[23] stated:

> Such allocation and apportionment of deductions may be necessary to determine taxable income from certain sources and activities for purposes of certain operative sections of the Code including section 904(a)(1). . . .

Since the proposed regulations, if enforced,[24] will have the effect of materially increasing the deductions allocated or apportioned to foreign source income, those regulations will frequently operate to reduce the amount of the foreign tax credit below what had heretofore been understood as an allowable credit. An example may illustrate the impact of the proposed regulations.[25]

Domestico, Inc., a U.S. corporation, manufactures automobiles. As a general operational procedure it engages in continuing research and development both for improvements of existing products and discovery of new products. Domestico has continually deducted the expenses incurred in that research and development program under section 174.[26] An average of 20 percent of Domestico's annual sales are to foreign customers, almost all of which have relatively high tax rates. The figures which Domestico might reflect on its income tax return for any year under its present method of treating R & D expenses are these.

	(000)
a. U.S. Gross profit	80,000
b. General overhead	(50,000)
c. R & D expenses (total)	(10,000)
d. Net U.S. profit	20,000
e. Total foreign sales	20,000

22. Section 861 sets forth the source of income for nonresident aliens of foreign corporations.

23. Proposed Treas. Reg. § 1.861-8, 38 Fed. Reg. 15840 (1973).

24. Practitioners in various major cities have informed this writer that some agents of the Service are presently applying the proposed regulations as if they were final.

25. The example is an abbreviated version of the example in the proposed regulation § 1.861-8(g) Eg. 1, 38 Fed. Reg. 15840 (1973).

26. That section provides that research and development expenditures incurred during the taxable year may be treated as a deduction.

f. Expenses allocated to foreign sales	(5,000)
g. Net foreign income	15,000
h. Foreign tax payments (40%)	(6,000)
i. Foreign after tax profit	9,000
j. Total U.S. taxable income (d. + g.)	35,000
k. U.S. tax (est. 45%)	15,750
l. Foreign tax credit	(6,000)
m. Total U.S. tax	9,750
n. Total increase in e & p (20,000 + 15,000) minus (6,000 + 9,750)	19,250

Under the proposed regulations, however, 20 percent of the R & D expenses would have to be allocated to foreign sales, with the following results.

a. U.S. gross profit	80,000
b. General overhead	(50,000)
c. R & D expenses (U.S. portion)	(8,000)
d. Net U.S. profit	22,000
e. Total foreign sales	20,000
f. Expenses allocated to foreign sales	(5,000)
g. Foreign income share of R & D expenses	(2,000)
h. Net foreign income	13,000
i. Foreign tax payments[27]	6,000
j. Total U.S. taxable income (d. + h.)	35,000
k. U.S. tax (est. 45%)	15,750
l. Foreign tax credit[28]	(5,850)
m. Total U.S. tax	9,900
n. To e & p after tax payments	19,100

As a result of the application of the apportionment concepts under the proposed regulations, Domestico has lost $150,000 of after-tax earnings. The proposed regulations apply that allocation concept

27. The example assumes that most foreign countries will ignore the Treasury's attempts to export deductions and assess tax as they traditionally have. Thus, as a result of the proposed regulations, the net effective foreign tax rate has gone from 40 percent to 46 percent. That figure is enough to alert the tax manager for Domestico that excess foreign tax credits are probably being generated.

28. The limitation formula of section 904 was applied at that point in the calculation. Assuming all income and taxes were from one country, the formula is: foreign country income divided by total taxable income, times the U.S. tax, or in figures: 13,000/25,000 x 15,750 = 5,850 tax credit.

to a number of items (such as interest and overhead) although the dramatic impact of the proposed regulations is most apparent when applied to research and development expenses.

b. Sales of the Celidicite to the Venezueluan Operation, Section 482.

A continuing and perplexing problem for non-consolidated related taxpayers who deal with one another springs from the eight short lines found in section 482.[29] Briefly, the section provides that in commercial transactions related parties are to deal with each other at arm's length "in order to prevent evasion of taxes or clearly to reflect" income. If the taxpayer does not deal with a related party at arm's length, the appropriate District Director is authorized to reallocate income to the proper party. The significance of that power may be seen in the following:

Assume that Washco sells the fully processed and refined celidicite in bulk form to the Venezuelan subsidiary for one dollar a pound. That figure becomes a part of the subsidiary's cost of the washers which it in turn sells. Assume further that Washco's net taxable profit is three cents per pound on which it paid sufficient Brazilian tax, so it receives a full U.S. foreign tax credit. The subsidiary processes the celidicite into 100 washers on which it realizes a taxable profit of two dollars, of which 80 cents is paid in tax to Venezuela. Three years later an audit by the Internal Revenue Service recommends that the sale price be raised from $1.00 per pound to $1.10. The result of that 10 cents per pound increase is to increase Washco's taxable income from three cents to 13 cents per pound. Assuming that the recommendation is accepted or confirmed judicially, the effect is that the United States will collect tax on an additional 10 cents per pound at 48 percent even though Venezuela will have taxed that same 10 cents at 40 percent—a total tax of 88 percent on that 10 cents.[30]

---

29. Section 482 reads as follows:

> ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

30. The profit calculation by the Venezuelan subsidiary was based on the theory that the celidicite cost $1.00 not $1.10. Had the price which the Service said should have been charged in fact been charged the profit would have been $1.90, not two dollars and the tax by Venezuela would have been 76 cents, not 80 cents.

Having focused on the section 482 problem, the difficult question is how to arrive at an arm's length price. Perhaps the place to commence the analysis (although certainly not the place to end it) is with the regulations. Although the regulations dealing with the sale of personal property by one controlled party to another have been somewhat maligned and abused, there are times when the contents of the regulations are useful.

If, for example, Washco were to sell the celidicite in substantially the same form to unrelated customers, the price at which it should sell to the Venezuelan subsidiary is that same price.[31] Suppose, however, that Washco does not engage in that form of uncontrolled sale. Then the usefulness of the regulations begins to break down. The regulations describe two additional methods for calculating an arm's length price in that situation. The first of the two is referred to as the resale price method. That method envisions the controlled buyer reselling the property in an uncontrolled sale to a third person without first having altered or added to the item sold.[32] The method is not available to Washco, however, because the Venezuelan subsidiary will use the celidicite as raw material in its operations—not resell it.

The second of the two is referred to as the cost-plus method. That method is used when the product sold (the celidicite) is included in a final product by the buyer, which final product is sold to third party customers. Under that method the seller arrives at an arm's length price of the basic product or raw material to the related buyer by adding to the cost or production an "appropriate gross profit percentage" plus or minus certain adjustments.[33] The problem with that formula is that in order to be effective the gross profit percentage must be based on the gross profit earned by the seller or another party (presumably a competitor) from uncontrolled sales of property which are most similar to the controlled sale in question. Since there are frequently not any sales that are close to the nature of the sale as to which an arm's length price is needed, the resale price method is generally of little assistance to taxpayers with the arm's length price problem.

---

31. Treas. Reg. § 1.482-2(e)(1)(1968). That paragraph in the regulations describes the comparable uncontrolled price method of calculating the arm's length price to be charged by one controlled member to another. Although the Service has tried to avoid the thrust of those regulations, the regulations have received judicial approval.

32. Treas. Reg. § 1.482-2(e)(3)(1968).

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

If none of the three methods described in the regulations is applicable, then Washco can apply what is generally known as the fourth method:

> Where none of the three methods of pricing. . .can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described . . . or variations on such methods may be used.[34]

What that provision provides, in effect, is that if the taxpayer can demonstrate that none of the three methods outlined in the regulations applies, he can use his own.

How each taxpayer arrives at its own method varies from taxpayer to taxpayer, of course. The most frequently applied method is either a guess or the number that the treasurer or comptroller thinks the company can get by with. Although that system works fine until there is an audit by the Service, it is of little value when the Agent asks for an analysis of how the particular price was determined to be an arm's length price. It is when the Agent asks that potentially embarrassing question that one wishes that some planning had gone into the determination of price.

We recommend to our clients that they prepare for the section 482 audit before it arises. That means doing an analysis of how the price was determined. If appropriate, hire an economist[35] and rely on his report and recommendations. Ask both tax counsel and tax accountants for advice and guidance. But more than any factor, weigh heavily the concept of planning and supporting what ever decision is made.[36]

c. Summary of Considerations in Operating Through a Division in Brazil.

Perhaps the most relevant factor in the consideration of whether or not Washco should operate through a division in Brazil is that the income earned and deductions generated in Brazil by Washco are reflected currently in Washco's income tax return. As a result, the only overtones which are material that are in addition to domestic operational tax problems for Washco are the foreign tax credit calculations and reallocation problems created by section 482. Hence, in view of the additional complexity which a foreign subsidiary brings to any corporate structure, the Brazilian operation should probably be conducted through a division unless there are (a) local law require-

34. Treas. Reg. § 1.482-2(e)(1)(iii)(1968).

35. The Office of International Operations of the Service had, at last count, eight economists on its staff working on section 482 cases.

36. For a further discussion of section 482 see the discussion of that section contained in 2 RHOADES § 7.

ments which dictate a separate corporation; (b) other legal aspects of the arrangement which indicate separate incorporation is appropriate (e.g. limited liability) or (c) compelling economic reasons which indicate there are advantages to being able to control the flow of profit from Brazil through a separate corporation.

If, however, Brazil requires Washco to separately incorporate its Brazilian operations, the income tax aspects of that act are considered in the next section.

5. *Operations in Brazil Through a Brazilian Subsidiary.*

Having determined there are sound reasons for incorporating the Brazilian operation, you are immediately faced with the problem of where to incorporate. It may well be that the reason for incorporating in the first place will also dictate where to incorporate—probably in Brazil. But, if it does not and there is a decision to be made, you have a broad range of choices. Those countries which you would consider seriously are Brazil (of course), Venezuela (effectively combining the two operations), a tax haven island such as the Caymans (to avoid, perhaps, Brazil's income tax) or even the United States (to take advantage of the Western Hemisphere Trade Corporation provisions). For the purposes of this article we are concluding that Brazil has been selected as the proper country for incorporation.

6. *Problems Created by Incorporating a Foreign Corporation.*

The Internal Revenue Code does not present any obstacle to incorporation in a foreign country if the property transferred to the foreign corporation is cash or other property not appreciated above its basis. If Washco begins its operations in Brazil through a Brazilian subsidiary before it has any mining claims or operating personnel in Brazil, incorporation is rather routine. If, however, the decision to incorporate is not made until after Washco has obtained an interest in the celidicite mines in Brazil a problem arises. The problem is found in section 367 of the Code. Before turning to the provisions of that section, a short review of section 351 is in order to help place the problem in perspective. The reader may recall that the exchange of property for shares between a corporation and its shareholders when a new corporation is created would, but for the provisions of I.R.C. section 351, result in taxable gain to the transferor of the property. The amount of the gain, of course, is the difference between the shareholder's basis in the property and the fair market value of the property. Section 351, however, precludes the gain from being recognized in such cases with the result that tax free incorporation of a domestic corporation with low-basis, high-value property is a common occurence.

Alter the facts to attempt an incorporation of a foreign corporation with appreciated property and the results are substantially different. Section 367 provides in part that gain is to be recognized in an otherwise tax free reorganization (including that described in section 351) if a foreign corporation is one of the parties to the transaction unless the transferor first obtains a ruling from the Commissioner that the contemplated exchange is not pursuant to a plan that involves tax avoidance as one of its principal purposes.[37]

That section poses significant problems for the company planning to transfer property to a foreign corporate subsidiary. Although frequently a ruling can be obtained by paying the appropriate "toll charge"[38] the ruling will take time to obtain. There are two answers to the problem presented by section 367. One, treat the transaction as completely taxable from the outset, establish as low a valuation on the appreciated property as feasible and prepare to fight to support the valuation later. Two, and a frequently more palatable solution to your client, is to incorporate the foreign corporation for cash and then cause it to purchase the asset or assets from the transferor. The major difficulty with that solution is establishing a price. Perhaps the most flexible manner of achieving the goal of a fair price and yet avoiding the creation of an immediate tax problem for the transferor is to obtain an appraisal of the property and cause the foreign corporation to buy it on the installment basis. If an appraisal is impractical, estimate the value of the property and let the foreign corporation buy it on a work-out basis similar to the method used by larger companies to buy stock of a closely held corporation.

The additional problems involved with creating a foreign corpo-

---

37. That description is an oversimplification. The operative language of section 367 is:

> (a) GENERAL RULE. In determining the extent to which gain shall be recognized in the case of any of the exchanges described in sections 332, 351, 354, 356, or 361, a foreign corporation shall not be considered as a corporation unless
> (1) before such exchange, or
> (2) in the case of an exchange described in subsection (b), either before or after such exchange,
> it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Although the phrase "a foreign corporation shall not be considered as a corporation" is peculiar verbiage to achieve the result Congress intended, there is now no doubt that they meant that gain on the transaction is to be recognized unless the appropriate ruling is obtained.

38. Rev. Proc. 70-18, 1970-2 CUM. BULL. 493, sets forth the procedures to be followed in applying for, and probable results of, an application for a ruling under section 367.

ration are similar to those encountered in creating a domestic corporation. The corporation must have employees and otherwise must be viable and active.

7. *Operational Considerations.*

Washco's Brazilian subsidiary—Washco-Brazil—will create operational difficulties for Washco which although neither costly nor insoluble are, however, a nuisance and require continuing care. The statutory foundation from which those difficulties arise is found in Subpart F of the Internal Revenue Code,[39] the subpart containing perhaps the most complex sections in the Code. Since it is likely that your advice will involve the creation of a foreign corporation either in Brazil or another foreign country, a review of Subpart F at this point is appropriate.

8. *The Concept Behind Subpart F.*

Before turning to the substantive parts of Subpart F it may be helpful for the reader to be aware of the purpose behind its enactment. The basic problem which Congress attempted to resolve was created by a substantial number of multi-national firms creating foreign subsidiaries in low tax countries and diverting profits to those countries which escaped both U.S. and foreign tax. That result was usually achieved by creating a sales subsidiary in Switzerland, the Bahamas or some other low tax jurisdiction. That subsidiary could then buy the parents' product (typewriters, photocopy machines, tires) from the parent at a 5-10 percent markup to the parent and resell the same product for a 20 to 50 percent markup.[40]

Because the concern of both the Kennedy Administration and Congress was the tax haven concept where profits were earned in one country but diverted to another, Subpart F tends to focus on the two country problem rather than concerning itself with operations in the same country where the corporation is incorporated. That tendency found its way into a number of exceptions to the rules set forth in the subpart which will be touched upon below.

9. *Statutory Overview of Subpart F.*

Subpart F is not a corporate taxation group of sections —it is a shareholder taxation group. By that we mean that Subpart F pur-

39. Subpart F includes sections 951 through 964 of the Code.

40. One of the questions often asked is why that profit could not have been reallocated to the parent under section 482. The answer is two-fold. One, section 482 in 1961-1962 (when Subpart F was drafted and enacted) was not the sophisticated device it has grown to become in the last 14 years; and two, even under section 482 as it is known today a reasonable profit would have to have been allowed to the foreign sales subsidiary—a result Congress found unacceptable. *Cf.* S. REP. No. 1881, 87th Cong., 2d Sess. (1962).

ports to tax shareholders of a controlled foreign corporation, not the foreign corporation itself. It is that concept of taxing only the shareholders rather than the corporation which gives the subpart its complexity.

To understand how the Subpart operates, the counselor must have a basic understanding of the terms which the Subpart uses. A short glossary of those terms follows:

> *Controlled Foreign Corporation* refers to a foreign corporation more than 50 percent of the *voting* stock of which is owned (or is treated as being owned) by U.S. shareholders.[41] A controlled foreign corporation is frequently identified by its initials—CFC.
>
> *United States Shareholder*. A U.S. shareholder is any U.S. person who owns or is treated as owning 10 percent or more of the voting power of a foreign corporation.[42]
>
> *Subpart F Income*. The group of sections in Subpart F deals with or reflects the presence of the Subpart F income concept. Subpart F income is that form of tainted income which the CFC is deemed to have distributed to its shareholders unless an exception applies.[43]

With those terms in mind, here is how, in rather simplified fashion, Subpart F operates. A U.S. shareholder (that is, a 10 percent or more owner of the voting power) of a CFC is required to take into his income as a constructive dividend his pro rata share (along with other U.S. shareholders) of the CFC's Subpart F income.[44] There are complex rules relating to when the constructive dividend is to be taken into income and how the pro rata share is to be calculated[45] but for the purposes of your problem they are not relevant since all of the shares of Washco-Brazil will be owned by Washco. Consequently, the

---

41. CODE § 957(a). There is a special rule for insurance companies. Under certain conditions the foreign insurance company will be classified as a controlled foreign corporation when more than 25 percent (rather than 50 percent) of its voting stock is owned by U.S. shareholders. CODE § 957(b).

42. CODE § 951(b). A United States person is any U.S. citizen or resident, domestic partnership or corporation or any trust or estate (except a foreign trust or foreign estate). CODE §§ 957(d), and 7701(a)(30). There are certain modifications in the definition required when Puerto Rican, Virgin Islands or other possessions' persons are involved.

43. Specifically, Subpart F income is composed of two parts—income derived from insurance of U.S. risks and foreign base company income. CODE § 952(a). Foreign base company income in turn is composed of three parts, foreign personal holding company income; foreign base company sales income; foreign base company services income; and, for years beginning after December 31, 1975, foreign base company shipping income. CODE § 954(a).

44. CODE § 951(a)(1)(A)(i). Additionally, he is required to take into his income his pro rata share of the CFC's increase in earnings invested in U.S. property—a concept discussed below.

45. CODE § 951(a)(2). There are also rules setting forth the manner of determining when shares are deemed to be owned by one person, when owned by another—the attribution of shares problem. CODE § 958.

primary question for you is how to identify the existence of Subpart F income. It is to that problem which we now turn.

Subpart F income is made up in part, you may recall, of two kinds of income, one of which was foreign base company income. That kind of income was in turn made up of three, soon to be four, different kinds of income, the only relevant one to your problem being foreign base company sales income.

"Foreign base company sales income" is income derived in connection with any one of the following: (a) the purchase of personal property from a related person and its sale to any person, (b) the sale of personal property to any person on behalf of a related person, (c) the purchase of personal property from any person and its sale to a related person or (d) the purchase of personal property from any person on behalf of a related person, where the country of incorporation of the CFC is not the country where the property was either created or to be consumed.[46]

Looking to that definition it does not appear that Washco-Brazil will generate Subpart F income at all, not only because it is incorporated in the country where the celidicite is being produced (the overall purpose of Subpart F was to attack transactions where the income was produced outside of the country of incorporation) but also because Washco-Brazil has not acted as a middleman—that is, it hasn't purchased and resold in a transaction involving a related party nor has it acted on any other person's behalf.

Even if Washco (the parent) mines the celidicite, sells it to Washco-Brazil which in turn sells it to the Venezuelan operation, the income would not be foreign base company sales income because, although Washco-Brazil indeed will have purchased and resold personal property, Washco-Brazil is incorporated in the country where the property is mined, thereby bringing into play one of the Subpart F exceptions. If, however, Washco-Brazil were incorporated in Panama and purchased and resold the celidicite to the Venezuelan subsidiary, that income would be foreign base company sales income.

Even though the income generated by Washco-Brazil will not be Subpart F income there are certain other problems created by Subpart F which must be considered. The primary problem, of course, is how Washco-Brazil should handle its retained earnings once operations are under way.

The immediate response of many clients when a cash surplus begins building in the subsidiary is to lend the cash to the parent corporation or otherwise use it in the parent corporation's U.S. busi-

46. CODE § 954(d)(1).

ness. It is that intended use of the funds which raises the problems of a constructive dividend once again.

Section 956 provides that if a CFC (which Washco-Brazil is, of course) increases its investment of earnings in U.S. property, the amount of that increase will be a constructive dividend to the U.S. shareholders:

> Example: Washco-Brazil has been operating in Brazil long enough to generate $1,000,000 in retained earnings. Washco-Brazil does not own any U.S. property. It loans $500,000 to Washco on a long term basis. Since the obligation of a U.S. person is U.S. property, that $500,000 loan will, if still in force over the turn of Washco-Brazil's fiscal year, will be a constructive dividend to Washco.

While considering section 956 problems, there are two broad categories of issues to consider: (1) whether the investment in U.S. property is an investment of earnings and if so whether there is an increase in that investment;[47] (2) to identify those items which are U.S. property and those which are not. U.S. property includes, generally, all tangible real and personal property located in the United States and intangibles such as stocks, securities and even obligations of a U.S. person.[48]

Hence, Washco-Brazil has the problem of investment of its excess earnings. Although there may be problems connected with the answer, there is the alternative of lending the funds to a sister corporation, buying real estate in other countries or otherwise investing in a foreign country.[49]

---

47. The determination of whether there has been an increase in the CFC's investment in U.S. property is not as easy to make as it might appear. The primary consideration is one of timing. The determination of whether the CFC owns any U.S. property is made at the end of its fiscal year. Pro ration during the year is not required. CODE § 956(a)(1). The amount of U.S. property deemed owned by the CFC is the adjusted basis of the property in the hands of the CFC, reduced by any liability to which the property is subject on the last day of the fiscal year. CODE § 956(a)(3). All earnings are used to calculate earnings—that means pre-1962 earnings as well as non-CFC income earned by the CFC. There are other rules for determining the proper calculation of Subpart F income, but the above suggest, at least, the complexity of the calculations. See 1 RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 3.04 (1975) for further discussion of the section.

48. CODE § 956(b)(1). The most important of the U.S. property definitions is an obligation of a U.S. person. The term "obligation" means any debt, note, debenture, account receivable or the like, but does *not* include a short term obligation—that is, a debt which is collected within one year from the time it is incurred or is not collected solely because the debtor is unable to pay. The short term debt, in order to escape the definition of "obligation," must not have been incurred in connection with the sale or processing of property. Treas. Reg. § 1.956-2(d)(2)(1964).

49. The primary problem is that the income from the investment will most likely be foreign personal holding company income as defined in CODE § 954(c). As such, it is Subpart F income and susceptible to being treated as a constructive dividend.

10. *Liquidation or Sale of Stock in a Foreign Subsidiary.*

As an advisor, you should at least alert your clients to the non-capital gain aspects of a liquidation of a CFC. The reason is that frequently many businessmen approach an investment as being short or medium term with a view to liquidating their investment and paying tax at capital gains rates. Hence, the provisions of section 1248 can be an unpleasant surprise unless they are forewarned.

The primary rule for the shareholder to bear in mind while considering the impact of the law on disposition of the CFC's stock is that some part or all of the gain will be treated as a constructive divident to the shareholder.[50] Section 1248 provides, in broad terms, that if the U.S. shareholder[51] of a CFC sells his stock or otherwise disposes of the stock—even one share—in a taxable transaction[52] a portion of the gain is to be included in the gross income of the shareholder as a dividend. The amount of the gain which is to be treated as a dividend is equal to the pro rata share of the CFC's earnings and profits attributed to the shares which were sold:

> Example: Washco-Brazil has issued 1,000 shares to Washco, Inc. During the three years Washco-Brazil has been in operation it has accumulated $2 million in earnings. Washco, Inc., elects to sell 250 shares to local Brazilian citizens for a total of one million dollars. If the basis of the Washco-Brazil shares in Washco, Inc.'s hands was $100,000, the amount treated as a dividend to Washco Products, Inc. is calculated as follows:

Sales Price	$1,000,000
Less basis	(100,000)
Recognized gain	900,000
Amount of earnings attributed to shares sold (.25 x 2,000,000) and treated as a dividend	500,000
Amount treated as capital gain	400,000[53]

Note that the gain is characterized as a dividend rather than simply being treated as gain from the sale or exchange of property which is not a capital asset.[54] The difference to the individual shareholder

50. CODE § 1248.

51. A U.S. Shareholder is any shareholder of a CFC who owns 10 percent or more (directly or constructively) of the voting power of a CFC. CODE § 951(b).

52. The operative words are: "than the gain *recognized* on the sale or exchange of such stock" (emphasis added). CODE § 1248(a). See also Treas. Reg. § 1.1248-1(c) (1964).

53. It may be that Washco is not as well off treating a portion of the sales price as a capital gain as it would have been treating it all as a dividend, since the dividend carries a foreign tax credit with it.

54. Examples of other sections which adopt the sale of assets approach are CODE § 306(a)(1)(A) (disposition of section 306 stock) and § 341(a) (collapsible corporations).

between those two concepts (dividend treatment and non-capital asset treatment) is insignificant.[55] To the corporate shareholder, however, the difference is material, because the dividend aspects of the gain carry a foreign tax credit potential. Thus, upon a 1248 sale, the amount treated as a dividend carries the same foreign tax credit privileges as do actual dividends from foreign corporations.[56] Distributions which are liquidating dividends are not treated as dividends for purposes of the deemed paid tax credit and hence are not entitled to a deemed paid tax credit under section 902.[57]

There are a number of exceptions, limitations, and modifications to the rules of section 1248 which are far too numerous to discuss in this article.[58]

C. *Creation of Operations in Venezuela.*

1. *Review of Those Facts Relating to Venezuela.*

Under the fact pattern established for you by your new client, you were told that although the celidicite was to be mined in Northern Brazil, it was to be processed in Venezuela. The reason for that conclusion was that it was substantially more convenient, local laws were more hospitable and that area of Venezuela offered a broader-based labor pool.

The non-tax factors related to: creating a processing facility in the proper area; buying the plant, equipment and supplies; hiring qualified labor and a host of other matters, some trivial, some important.

Prior to taking any steps to solve those problems, however, you must come to grips with the operational structure. Almost immediately four alternatives present themselves. The plant can be operated (1) as a division of Washco Products; (2) as a Venezuelan subsidiary; (3) as a division of Washco-Brazil; or (4) as a foreign corporation in Venezuela but incorporated in another country.

---

55. The dividend treatment does not entitle the individual shareholder to a dividend exclusion because that rule only applies to dividends from domestic corporations. CODE § 116(a).

56. Treas. Reg. § 1.1248-1(d)(1)(i)(1964).

57. Freeport Sulphur Co. v. United States, 163 F. Supp. 647, 58-2 USTC 9700 (Ct. Cl. 1956) *mdf'd on other grounds*, 172 F. Supp. 462, 59-2 USTC 5939 (Ct. Cl. 1959). *See also* Fowler Hosiery Company v. Comm'r, 301 F.2d 394, 62-1 USTC 9407 (7th Cir. 1962) and Associated Tel. & Tel. Co. v. United States, 306 F.2d 824, 62-2 USTC 9659 (2d Cir. 1962) *cert. denied*, 371 U.S. 950. *Contra*, Hay v. Comm'r, 145 F.2d 1001, 44-2 USTC 9522 (4th Cir.) *cert. denied*, 324 U.S. 863 (1945). The Hay case is probably bad law and of dubious value at best.

58. The rules of the section only apply to U.S. shareholders. Hence, they do not apply to those whose voting power does not equal 10 percent. The rules do not apply to earnings attributable to Subpart F income to the extent previously taken into income by the U.S. shareholder. A corporation that is a less developed country corpora-

2. *Operations as a Division of Washco Products.*

Although the considerations may appear to be the same as those you weighed while determining if Washco-Brazil should operate as a division or a subsidiary of Washco Products, there are some differences. One, Washco's operations in Brazil were in an extractive industry. That business carries its own special tax considerations—e.g. depletion allowance. Two, the effective tax rate on operations in Venezuela may well be different than the rate in Brazil. The legal considerations (as compared with the financial result flowing fom the application of those considerations) are substantially similar however. Hence, you must once again review the foreign tax credit provisions and the provisions of section 482, but this time, with the Venezuelan operation in mind.

3. *Operations in Venezuela Through a Subsidiary Incorporated in Venezuela.*

The U.S. legal problems which your client will encounter by incorporating in Venezuela are substantially similar to those it encountered in considering incorporating in Brazil. First, local law must be considered as a prime factor in the decision regarding incorporation.[59] That factor, of course, requires the employment of local counsel.

Assuming local law is compatible with your client's goal (as it usually will be in a new business activity context), U.S. law—mainly the Internal Revenue Code—becomes your most difficult problem. In view of the operation to be carried on in Venezuela, however, the problems are probably going to be less severe than incorporating in Brazil, with one major exception. The reason section 367 will, for the most part, not be a material problem is that acquisition of the plant, machinery, supplies, inventory and labor will most likely be on a cash (or credit) basis. Consequently, the section 367 problem frequently encountered upon the creation of a new foreign corporation[60] may well not be encountered in the incorporation of Washco-Venezuela. Additionally, even if the parent donates plant equipment to the foreign subsidiary, it is likely that there will be little gain or indeed a loss[61]

---

tion can shelter its shareholders from the impact of section 1248 in some cases. The tax on individuals is limited mathematically. There are other exceptions, but the above list suggests the complexity of the section.

59. As an example of the broad effect which local law can have on operations within a foreign country, see the Decrees promulgated by President Carlos Andres Perez on April 28, 1974 (published as Decrees No. 62 and 63 in Gaceta Official No. 1.650 Extraordinario, April 29, 1974) describing the rules pursuant to which foreign companies are allowed to operate in Venezuela.

60. As described above, section 367 provides that the transfer of appreciated property to a foreign corporation requires an affirmative ruling to avoid recognition of gain.

61. One aspect of section 367 is that it cannot be used by the taxpayer. Not only

so that the failure to obtain a ruling may be of little practical consequence.

The one material exception to that general conclusion relates to the transfer by Washco Products of the know-how which forms the basis for manufacture of the washers in Venezuela. Presumably, the process used in the manufacture of the washers was developed over a period of time in the United States by Washco Products and is being transferred to the Venezuelan subsidiary. That transfer raises an immediate section 367 problem. The initial issue relates to the method of transfer. The process can be transferred pursuant to any one of three methods: one, by license; two, by sale; or three, by capital contribution.

License. A license of the process does not involve section 367, at least on its face. If the license payment is arm's length royalty, then an exchange as described in section 351[62] has not occurred and, hence the section is simply not applicable. Section 482 is more likely to be applicable than is section 367, for under the regulations if the royalty payment is not an arm's length payment, the District Director is authorized to reallocate income in order to properly reflect an arm's length price.[63]

A further consideration is the probability that a withholding tax will be imposed by Venezuela on the royalties.[64] Although the tax is a creditable tax under section 901[65] that tax may, when added to other creditable foreign taxes, increase the available foreign tax credit above the limitation provisions of section 904.[66] If the credit-

---

are losses not allowed in transactions that would be tax free if a ruling were not needed, (the section speaks in terms of gain that is to be recognized), but also the taxpayer is not allowed to offset gains with losses arising from the same transaction. American Mfg. Co., 55 T.C. 144 (1970); Rev. Rul. 192, 1967-1 CUM. BULL. 141. Thus, if Washco Products contributed a number of pieces of equipment to Washco Venezuela, some representing a gain and some a loss, the full amount of the gain would be subject to taxation, irrespective of the loss items.

62. Section 351 relates to the tax free incorporation of appreciated property when the transferor has control of the recipient corporation immediately after the transfer.

63. Treas. Reg. § 1.482-2(d)(1)(i)(1968).

64. According to one authority, the withholding tax on royalties paid by a taxpayer in Venezuela for use of property other than films is 15 to 50 percent on 80 percent of gross income. Diamond, *Foreign Tax and Trade Briefs, International Withholding Tax Treaty Guide*, in VENEZUELA (1975).

65. Note that the withholding tax is a direct tax on Washco Products under Section 901, rather than an indirect tax as is the case of Venezuelan income tax on Washco-Venezuela's income which is subsequently remitted to the parent and creditable under the provisions of section 902.

66. The foreign tax credit limitation provisions are discussed above in text following note 17.

able taxes do exceed the limitation amount, then it may well be that the license route is excessively costly.

Sale. The problems created by a sale of the process are similar to those found in the license, except that (1) the proceeds received from Washco-Venezuela should be treated as capital gain rather than ordinary income,[67] and (2) there *may* not be withholding tax if Venezuela treats the proceeds as something other than a royalty payment. The section 482 problem persists, however, although the likelihood of a 367 problem remains small.

Capital Contribution. If Washco Products transfers the process to Washco-Venezuela without consideration, section 367 presents a significant problem. Assuming that the process is "property"[68] and has a zero basis, the taxpayer, Washco Products, will be deemed to have transferred the property in exchange for Washco-Venezuela's stock,[69] which will not qualify for non-recognition if a favorable ruling is not obtained. Thus, if the value of the process were $3,000,000, Washco Products will be deemed to have exchanged the process for $3,000,000 worth of Washco-Venezuela's stock in a taxable transaction.

If, however, Washco Products decides to request a favorable ruling, you as the advisor must determine the probability of success and what charge, if any, may be assessed. Your Bible, for that purpose, is revenue procedure 68-23.[70] Under that revenue procedure, a decision by the client is necessary. A favorable ruling would probably be issued unless the service concludes that (a) Washco-Venezuela is itself going to resell the process (unlikely),[71] or (b) the property being transferred consists of:

> United States patents, trade-marks and similar intangibles to be used in connection with (1) conduct of a trade or business in the United States, or (2) the manufacture in a foreign country of goods for sale or consumption in the United States.[72]

---

67. One of the frequently hidden issues found when the taxpayer transfers intangible assets in a taxable transaction is whether the intangible is properly classified as "property" or something else, such as an "idea" or an "inventive conception." That problem must be considered because the taxpayer is entitled to capital gain treatment only on the gain from the sale or exchange of *property* held for more than 6 months. CODE §§ 1221; 1222(3). See Rev. Rul. 56, 1964-1 CUM. BULL. 133, for a discussion of the meaning of "property" as used in the Code. See also Rhoades & Wallen, *Section 1235: What it Does (and Does Not) Do as to Inventions—Patented and Otherwise*, 20 U. SO. CAL. 1968 TAX INST. 677 for a broader discussion of the issue.

68. A trade secret is property in the section 367 context. Rev. Rul. 564, 1971-2 CUM. BULL. 179.

69. CODE § 367(d).

70. 1968-1 CUM. BULL. 821.

71. Rev. Proc. 23, 1968-1 CUM. BULL. 821, § 3.02(1)(a)(iv).

72. *Id.* at § 3.02(1)(b)(iii).

If Washco Products cannot demonstrate that all of its foreign produced washers will be sold overseas, it may not be entitled to a favorable ruling. In either event, a degree of planning before the ruling application is prepared is appropriate.

4. *Operations in Venezuela Through a Division of Washco-Brazil.*

One of the factors to consider in the creation of the foreign corporate structure is whether Washco-Brazil should extend its operations to Venezuela.

Once again, both Brazilian and Venezuelan local law must be considered. One of the key questions, of course, is whether either state has a legal objection to such an arrangement. If it does not, your client is once again required to turn to the Internal Revenue Code for direction. As a branch or division of Washco-Brazil, the Venezuelan operation would not be a related party, nor would it buy the raw material from Washco-Brazil; rather, Washco-Brazil would merely ship the material to the Venezuelan processing plant for manufacture into the washers.

Two questions are raised at this point. One, how will the Venezuelan tax structure affect overall profits of a Brazilian corporation; and two, is there any different U.S. income tax result arising from the corporate structure involving a division of the Brazilian corporation rather than the use of a Venezuelan corporation?

The first issue is one which you, as U.S. counsel, are ill-equipped to handle. It simply must be referred to local counsel.

The second issue is by far more difficult. It raises a number of sub-problems to consider. One relates to the deemed paid foreign tax credit.[73] Since Washco-Brazil would be paying taxes to both Venezuela and Brazil, how should those taxes be treated when Washco-Brazil distributes earnings to Washco Products?[74]

Another sub-issue is the same as the issue that arose when we were considering incorporating in Venezuela—that is, transferring the know-how and other assets to the foreign subsidiary. The problem remains the same, whether the foreign corporation is Brazilian or Venezuelan.

A third sub-issue relates to what is referred to as the "branch rule."[75] The branch rule provides that in certain cases branches of a CFC are to be treated as if they were wholly owned subsidiaries of the CFC. That rule, however, is applicable only for determining foreign base company sales income and not for any other purpose. Since

73. CODE § 902.

74. The response to that inquiry is that all income is aggregated, as are all foreign taxes, and treated as being derived from taxes paid to Brazil.

75. The branch rule is found in section 954(d)(2).

the transfer of the raw material by Washco-Brazil to the Venezuela operation, if it were a sale, would not create foreign base company sales income, the branch rule is not material.

In view of the foregoing analysis, from a U.S. standpoint, there is no material difference, conceptually, between the two structures, a Venezuelan subsidiary or a branch in Venezuela of the Brazilian operation. Hence, the two subsidiary structures will very likely be preferred over the single subsidiary-branch structure, because two subsidiaries offer more flexibility than does a single subsidiary with a branch in terms of planning, allocating income between Brazil and Venezuela and other steps.

5. *Operations in Venezuela Through a Corporation Incorporated in Another Foreign Country.*

The problems presented by the incorporation of the Venezuelan operation in another foreign country, such as a tax haven (e.g., the Cayman Islands, Netherlands Antilles) are again either local problems or U.S. tax problems. The tax problem involved is also found in Subpart F of the Code. You may recall that foreign base company sales income is income derived from the purchase and resale of personal property by a CFC to a related person[76] where the property is produced in a country other than the country of incorporation. As a matter of common sense (an element frequently lacking when tax laws are drafted), it would seem that any income generated by a CFC which arises from activity other than the purchase and resale of property should not be classified as Subpart F income. Common sense did indeed prevail and that is the rule.[77] Thus, if a CFC purchases raw materials, processes them and sells the product it has processed, Subpart F income will not be generated.

Applying that rule to the Venezuelan operation, the issue is whether conversion of the raw material of celidicite into washers is "manufacturing" within the scope of the rule. If it is, the income generated by the Venezuelan operation will not be Subpart F income even though the corporation is not incorporated in Venezuela. If the activity in Venezuela does not rise to the status of manufacturing or processing, however, then the income generated by the Venezuelan operation will be Subpart F income and hence must be considered

76. Foreign base company sales income also includes purchases of personality from a related party and its resale to a third person.

77. Treas. Reg. § 1.954-3(a)(4)(1963). The rule may be paraphrased as follows: If the CFC manufactures, processes, or constructs products from parts and materials which the CFC has purchased, the income which the CFC realizes from the sale of such products is not Subpart F income, irrespective of the country in which the goods are manufactured or processed or the country in which the products are to be consumed.

income by Washco Products.

An item or commodity is "manufactured" within the meaning of the regulations if it is "substantially transformed" by, in our situation, the Venezuelan operation.[78] Some examples of manufacturing in the regulations are woodpulp to paper; steel rods to bolts and screws; fresh fish to canned fish.[79] In view of those examples, there is little doubt that conversion of the celidicite to washers is manufacturing and thus the income generated by the sales of those washers is not Subpart F income.

D. *Operations in Europe.*

Your client is psychologically against a multiplicity of corporations, so he has requested that you establish one, or at most two, corporations in Europe, even though Washco Products' plumbing line will be sold in all of the countries of Western Europe.

In view of that request, you tentatively decide to establish one corporate selling organization in Switzerland, which will acquire a warehouse in France and distribute not only Washco Products' line, but other plumbing products throughout Europe.

Because Washco's line is rather narrow (selling only rubber and plastic base plumbing products—no hardware) the client has estimated early years sales to be low, but growing materially in late 1978 and 1979 as follows:

Year	Washco's Products	Others' Products
1975	$ 200,000	$600,000
1976	450,000	750,000
1978	950,000	850,000
1979	1,800,000	750,000

Those figures are significant to you because if the bulk of the Swiss subsidiary's sales are in countries other than Switzerland, as is most likely, then the income generated by sales of Washco's products is a classic example of foreign base company sales income. A material question, however, relates to the manner of treating the sales of non-Washco products. We now turn to a rule developed to answer that question.

Subsection (b) of section 954 contains a number of exclusions and special rules. One of those rules, called the "30-70 rule,"[80] pro-

78. Treas. Reg. § 1.954-3(a)(4)(ii) (1963).

79. Treas. Reg. § 1.954-3(a)(4) Exs. 1-3 (1963). See also Dave Fischbein Mfg. Co., 59 T.C. 338 (1972) for a thorough discussion of the rule.

80. As a result of the Tax Reduction Act of 1975, P.L. 94-12, the 30-70 rule will become as of the beginning of 1976 the 10-70 rule. That change results from an amendment to Section 954 (b)(3)(A) reducing the 30 percent figure to 10 percent. P.L. 94-12, § 602(e).

vides that if foreign base company income comprises less than 30 percent of the gross income of the CFC for the taxable year, then none of the CFC's gross income shall be treated as foreign base company income. Conversely, if more than 70 percent of the CFC's gross income is comprised of foreign base company income, then all gross income will be considered as foreign base company income.[81] Thus, the result of that rule on the Swiss subsidiary is as follows:

Year	*Result*
1976	None of the income earned by the Swiss subsidiary will be classified as Subpart F income because the sales of Washco's products constituted but 25 percent of the Swiss company's sales.
1977	In 1977, sales of Washco's products constituted almost 40 percent of the Swiss company's gross income, so the rule is inapplicable and that 40 percent is treated as Subpart F. The remaining 60 percent is treated as non-Subpart F income. Although the effect is to merely increase the CFC's returned earnings, there is no immediate effect on the U.S. shareholders.
1978	The result from 1978's operations is the same as from 1977, legally. The amount of income to be taken up as a dividend by Washco Products is $950,000 (less deductions), rather than the smaller $450,000 from 1977, but that is the only change.
1979	1979 brings an entire shift in result. The amount of Subpart F income—that is, foreign base company sales income—is just under 71 percent of the total income. As a result, under the 30-70 rule, the entire amount of the Swiss subsidiary's net income is to be taken into income by Washco Products.

After determining the amount of gross income which constitutes Subpart F income, the subsidiary then calculates the proper deductions to be allocated to that income in order to arrive at net taxable income which would constitute the constructive dividend.[82]

IV. CONCLUSION

The decisions involved in expanding a domestic operation to a multinational one are enormous in both number and complexity. Just the few decisions necessary to determine the answers to the legal questions discussed above have taken many printed pages to simply

81. CODE § 954(b)(3).

82. CODE § 954(b)(5). Subpart F income is defined as foreign base company income less deductions properly allocable to such income. The regulations for properly allocating deductions are found at Treas. Reg. § 1.954-1(c)(1964).

discuss, let alone resolve. And even those are but a few of the total commercial and other legal considerations involved.

They must be analyzed and weighed, however. There is no short cut, other than to break the overall job into parts and allocate them amongst a number of subordinates for decision. The one hopeful light is that after you do the first two or three, the rest become easier.