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United States Tax Aspects of East-West Investment

Let me start off with three basic points regarding taxation in East-West transactions. One, which you have heard, is that the tax situation with the Eastern country is often negotiable. As Henry suggested, you should negotiate that in advance. The second basic factor is that the statutory tax rules are often changed by a tax treaty, so once you find out what the statutory tax rules are in the country, you then look to a tax treaty to see if they are changed. The third basic is that the United States investor is very concerned with taxes in a foreign country, even though there is a foreign tax credit in the United States that absorbs some of the foreign tax, and hopefully all of the foreign tax.

In an ideal situation you would not have to worry about what taxes you have to pay to the foreign country; you would just send a little note in with your United States tax return saying, "We have paid $3.2 million to Poland, and we have deducted that amount from our tax bill, and the remainder is enclosed herewith." Unfortunately, you can't do it that way. There are a couple of things you have to take into account. One is that only income taxes are creditable, and that you have a whole host of other kinds of taxes which are real costs. Sometimes it is hard to know whether a certain tax is an income tax or another kind of tax, and the Internal Revenue Service will rule on that issue if you have patience. Where they are available, the treaties are indicative of which foreign taxes are income taxes and which are creditable. Another factor is that there is a thing known as a foreign tax credit limitation which I will not explain, but which means in practice that many companies cannot get credit for all of their foreign taxes. This means you have to know what the position of your company is in this respect. If it is in the position where the overall tax credit limitation prevents it from getting credit for all of its foreign taxes, then any foreign taxes saved will be of real importance to your company. Thirdly, the undistributed income of foreign subsidiaries is not subject to current United States tax, so that foreign tax, even if eventually creditable, is a real cost if imposed upon an operation in one of the Eastern countries that does permit you to have an equity interest in a business entity (that is, a subsidiary)

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there. The less tax that you have to pay, the more income you have to reinvest in the business.

Now, I will talk about basically four different types of transactions that one might conduct in Eastern Europe and will try to give you some of the United States tax and treaty considerations that one would have to think about in connection with each of them.

The first type of transaction would be rather simple, the financing of export transactions in Eastern Europe. The second would be the joint venture that somehow blossoms into a participation in a foreign entity, and then the more complicated area would be the industrial cooperation contract, the co-production arrangements, the barter arrangement, the complex of arrangements which are entered into with Eastern countries. The fourth is an office in Eastern Europe.

1. *Financing of sales and other transactions with Eastern Europe*: In most cases, if you make a loan to a foreigner, the foreign country will impose a withholding tax, so the United States bank or financial institution charges interest of $1,000, and it gets a check for $850, with a little note that the $150 was a withholding tax imposed by the foreign country.

My understanding is that in many many cases in Eastern Europe, you can arrange for the withholding tax to be eliminated. That would be true under even our treaties with some of these countries.

2. Now I will turn to the *joint venture* sort of arrangement, which some of the Eastern companies permit, under which the United States party is something like a shareholder in a foreign corporation. Now, the first issue to be faced by the tax adviser is whether the joint venture entity is a corporation for United States tax purposes. We have standard rules that have developed in other areas about which there is a great deal of experience. If it meets certain tests, then it qualifies as a "corporation." The tests are continuity of life, centralized management, limited liability, and free transferability of interests. Now, if it meets slightly more than two of these tests, then the foreign entity would tend to be treated as a corporation for United States tax purposes, and the characterization for foreign tax purposes would not be controlling. If it is important for you to know how the Internal Revenue Service will characterize your investment vehicle, you can apply for a ruling and the Service will give you its views.

If the foreign entity qualifies as a corporation, under current United States law the income of this foreign corporation is not taxed to the United States stockholder until distributed to it, so profits can be reinvested without having been reduced by any United States tax. This can be of considerable help in getting a new business going.

Once there is a distribution of profits to the United States investor, the United States law not only allows a credit for the investor's *pro rata* share of the foreign taxes paid by the foreign entity (as long as the United States interest is a 10 percent voting stock interest or its equivalent), there is also a credit for any withholding tax imposed by the foreign country on the remitted profits.

A foreign corporation's losses are not currently deductible for United States tax purposes. In computing the way in which a dividend from a foreign corporation or something created like a foreign corporation is taxed, you have to consider the meaning of "earnings" and "profits," and you have to use the United States standards for computing the earnings of a foreign corporation, regardless of what accounting rules are used for tax and other purposes in the foreign country; and that sometimes may be a problem.

You may transfer property to a foreign corporation without any tax, but this is one case where you would ordinarily need an advance ruling from the Internal Revenue Service, and if you don't get the ruling in advance, there is nothing the Internal Revenue Service can do to help you afterwards.

3. Now I will turn to what from the tax point of view is the most difficult area of East-West investment, and that is *the industrial cooperation agreement*. The reason that it is the most difficult is that basically this may involve a whole series of different transactions, in different combinations in different deals, where cash is not used and instead there is barter, there are exchanges.

Now I will just briefly go through seven types of tax issues that have to be faced in these kinds of transactions.

First, when you are selling or furnishing goods and you are not getting money but you are getting something else in exchange, one of the main questions is whether you are subject to tax in the year the goods leave the United States and are transferred to the foreign party or you are taxed at some later time. The question is whether there is a so-called "open transaction." An open transaction exists when there is no reasonable way of valuing the consideration furnished by the foreign party; so that if you sell a lumbering machine, a series of saws, for a lumber mill, and they are going to give you 10 percent of the output of that lumber mill for the next 10 years, it seems to me that there is no reasonable way of valuing that. You don't know what the output is going to be, and you don't know what the price of lumber is going to be; so in that case I think you would postpone the tax until such time as you see what you are going to get. You recover first your cost on the machine, then you would have your income. On the other hand, if you had another transaction where there was a more specific way of valuing the consideration, then you would have to pay tax in the year the goods left the United States.

The Internal Revenue Service tries very hard to value contracts so they can tax you immediately. There is ordinarily no foreign tax on sales transactions. There is a subsequent transaction if you receive goods, because then you are going to dispose of the goods, but I think that your cost of goods sold in the second transaction would depend on the treatment of your first transaction, which would ordinarily be based on fair market value.

The next tax point to consider is as to whether under the rules for "open transactions," recognition of income taxability can be postponed. A more formal way of postponing recognition of income is the installment method of sales, which is quite familiar to you all. This method would normally be available only in a cash sale, where there is a fixed price and less than 30 percent of the price is received in the first year.

The third tax issue to consider in one of these cases is whether you can take advantage of the "DISC" legislation (so long as it still exists). Ther only way that I could see using a DISC in a barter type of transaction would be with a "commission DISC," and I think it would work with a commission DISC. I do not think it would work with a "buy-sell DISC," because in the end you are receiving property which you cannot dispose of within the DISC rules.

The fourth point in industrial cooperation contracts to note is that sometimes you receive ordinary income and some other times you receive capital gains by making know-how, patents and other technology available to the foreign party; and there is a well-developed body of law telling when it is a capital gain and when it is ordinary income. Here is a case where you would ordinarily pay foreign withholding taxes and receive a foreign tax credit in the United States.

The fifth point to consider, and I think this pervades some other aspects of industrial cooperation contracts, is sometimes it is better to pay taxes than not to pay taxes. One situation where it may be is where the foreign country will either give you a certain amount net and take care of the taxes itself, or will give you a higher amount and then tax you. The way the mathematics works out, if you are subject to tax and it is a legitimate tax that would ordinarily be imposed on anyone, you are better off in many cases if you do take the higher amount and pay your own tax or permit them to withhold against the amount that is paid to you. Then you can claim the foreign tax credit and you are better off under those circumstances. This relates to Henry King's point that you have to look very carefully to determine the party on whom the tax is imposed. If the tax is imposed upon a licensor, he can claim a credit, whereas if it is imposed upon the licensee, the licensor cannot claim a credit.

Services are an important area with a whole body of tax learning related to it. Ancillary services that are related and very secondary to a transfer of technology, know-how or patents are taxed along with that, whatever consideration you receive. On the other hand, if services are a major item or separately provided for, they are separately taxed. You have ordinary income on service income, and you want to be careful as to what the source of income is.

That brings me to the last series of points that you have to know about in connection with industrial cooperation contracts; namely, that you must be very careful to know the source of the income, because that will affect your foreign tax credit limitation very much. There are different source rules for sales of goods, for payments for technical services, for royalties, for interest received. They all have their own set of source rules.

One conclusion to note from all this is that you should bring your tax adviser into the transaction early, because, for example, if you pass title to goods overseas or you sell through a DISC, you may have certain disadvantageous tax consequences that cannot be recouped *after* the transaction. You may want to change the normal terms, and even pass title to the goods overseas to help your foreign tax credit picture.

4. I will now briefly mention *an office in the East*. In most cases an office in the East is not going to be subject to tax, and that is usually provided in the agreement establishing the office. The treaty with the U.S.S.R. gives an unusually broad scope for Americans to operate an office in Russia without being subject to Russian taxes. There and elsewhere, if you cross a certain threshold you may be subject to certain taxes. Incidentally, some of our tax agreements permit you to sell goods that have been on display after a trade fair, without being subject to tax.

Henry King has mentioned treaties with third countries, and you may want to carry out certain transactions through third countries. There are advantages and there may be disadvantages, and you just want to be awfully careful that you don't save a bit in tax through a third country tax treaty and run into other problems that tax lawyers worry about.