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An Overview of Inbound Foreign Investment

By Michael W. Berwind*


INTRODUCTION

Over the last ten years, one of the most dramatic changes I have seen has been the tremendous increase in foreign investment in the United States. Current figures are hard to come by, but during the decade of the 1970’s, the level of foreign direct investment more than tripled in this country, reaching a total of about forty-eight billion dollars by the end of 1979. The reasons for this growth are not difficult to understand. In a world that is increasingly torn apart by internal political troubles, the United States is viewed as one of the most stable countries of all. Foreigners know that a dollar that is invested here today is going to be here tomorrow, even though there is a changing of the guard back in Washington.

In addition to its political stability, most foreigners perceive the United States as a country that is full of business and investment opportunities. I know it is hard to believe this as you watch the price of local real estate climb through the roof, but as my foreign clients keep telling me, it is all relative. If you think land prices are high in the United States, you ought to see what it costs to buy property in Hong Kong, in many parts of Europe, or in parts of the Middle East. Compared to those prices, property here looks like a real bargain. And at least until recently, many foreigners found our prices to be even more attractive because of the dollar’s poor performance against foreign currencies.

A third reason why foreigners have been attracted to U.S. investments is the fact that our laws are quite receptive toward it. There is a sharp contrast between the favorable climate we offer the foreign inves-

* This material is the transcript of Mr. Berwind’s presentation at the symposium.
tor and the situation many Americans face making investments outside the United States. If you have been reading the *Wall Street Journal* lately, you know that one of the hottest foreign countries for Americans to invest in is our next door neighbor, Mexico. Unfortunately, it is also turning out to be one of the most difficult. For one thing, it is hard to do business in Mexico unless you have a local partner. Assuming you can find such a person (no small feat in itself), you frequently get caught up in a tangle of bureaucratic red tape which leaves you spinning endlessly in circles without getting the necessary permits or certificates that you need to start doing business. If you are able to surmount that obstacle, you may encounter something that the *Journal* politely referred to as “shrinkage.” The easiest way to describe shrinkage is to tell you that $100 of inventory shipped from the United States winds up as about $80 worth of inventory when it gets to its destination in Mexico. Sometime after it crosses the border, about $20 ends up going to one middleman or another. The less polite but more candid way to refer to this phenomenon is to call it commercial bribery.

In contrast to the frustrating situation many Americans face when they invest or do business outside the United States, foreigners have a relatively free hand making investments in this country. To be sure, there are certain laws that can affect a foreigner’s investment or business plans. For example, if the foreigner wishes to invest in agricultural property or to enter a line of business which may have national defense or public welfare implications, he may find a number of laws which stand in his way. By and large, however, the U.S. welcomes foreign investment with open arms. Of course, depending on the particular investment, there might be some bureaucratic red tape to wade through, but it is usually quite manageable, particularly if the foreign investor is working with a good attorney or accountant. In addition, the incidence of commercial bribery in this country, compared with that overseas, is negligible.

**REPRESENTING FOREIGN CLIENTS**

This morning’s panel is going to talk about some of the tax problems facing foreigners who make inward investments in the United States. My purpose on the panel is to give you an overview of this area and, perhaps, a sneak preview of some of the things you will hear about in more detail later on. Before getting into my topic, however, I want to spend a few minutes discussing the general problem of representing a foreign client. Over the years, I have watched attorneys get the chance to represent foreign clients and, one by one, I have
watched most of them make the same basic mistake. That mistake is to assume that dealing with a foreigner investing or doing business in this country is no different from dealing with a domestic client. As common as that assumption is, particularly with attorneys who do not spend a lot of time in this area, it is one of the most dangerous mistakes you can make in your practice. I say this for two reasons. First of all, the laws of this country, including the U.S. Constitution, do not apply equally to residents and nonresidents. See, e.g., Johnson v. Eisentrager, 339 U.S. 763 (1950). Some laws, of course, are completely neutral in their application. Others, however, favor the domestic investor over the foreign investor. In this category I would put the various state laws that restrict an alien’s right to own land. See generally Report of Committee on Foreign Investment in U.S. Real Estate, Real Property Division. Foreign Investment in U.S. Real Estate: Federal and State Laws Affecting the Foreign Investor—an Update, 16 Real Prop. Prob. & Tr. J. 465 (1981). Surprisingly, there may even be a few laws which favor the foreign investor over U.S. citizens. There is a major case now pending before the U.S. Supreme Court which involves the Sumitomo Corporation. Avigliano v. Sumitomo Shoji America, Inc., 638 F.2d 552 (2d Cir. 1981), cert. granted, 102 S. Ct. 501 (1981), rev’d 102 S. Ct. 2374 (1982). At issue in the case is a little-known clause in the commercial treaty between the United States and Japan which says (in Sumitomo’s view) that their executive hiring practices can be conducted in complete violation of the U.S. civil rights laws. So, never get lulled into assuming that foreign clients face the same legal problems that domestic clients do, because they do not.

The second reason you cannot equate foreign and domestic clients is that as people, they are not the same. To put that a little less elegantly, foreign clients generally will not look or speak the way you do, and more importantly they will not think the way you do either. I feel so strongly about this point that if I am able to leave you with just one thought today, I would like it to be this one: whenever you work with a foreign investor, never forget that you are dealing with someone who comes from a cultural, legal, and business environment that is different from your own. Believe me, you ignore this advice at your peril.

To give you an idea of what can happen when a foreigner makes an inward investment in the United States, we had a client approach us not too long ago for assistance in acquiring a piece of real estate. The client had already located the property he wanted to buy. It was a large apartment complex in Los Angeles, with nicely maintained grounds and an ideal group of tenants. There had been no turnover for a
number of years. Everybody paid their rent on time. There were no loud parties. A landlord could not ask for more. Since the basic deal had already been negotiated, our involvement in the transaction was a fairly limited one. We were asked to draft the purchase agreement for the buyer and to review the various closing documents. This we did, and the transaction closed without any unexpected problems. Little did we know, however, what was just around the corner. As often happens in these cases, word got back to the tenants that someone was buying the building. They braced themselves for the all-too-familiar pattern of events: a new buyer followed by a big jump in rents. This time, however, everybody got a big surprise. Unbeknownst to anyone else (including us), our client chose to accommodate his purchase not by raising rents, but by cutting expenses: he fired everybody. He let the maintenance people go. He fired the groundskeepers. He even called up the local garbage service and said it would not be necessary to pick up the garbage anymore. You can imagine what happens to an apartment building following two or three weeks of total neglect.

Shortly thereafter, a few of the tenants made an informal request to our client that something be done to remove the animals that were starting to show up in the front yard. After receiving no response, they consulted a lawyer in Los Angeles who helped them draft a more formal letter demanding that certain steps be taken to improve things. When the letter got back to our client, he flew into a rage and blasted off a letter of his own informing the tenants that their “insubordination” was not going to be tolerated. As a forceful reminder of who the boss was, he announced that he was doubling their rent and removing all of their appliances; the stoves, the refrigerators, the washers, the dryers, everything was being taken from each unit. The poor lawyer representing the tenants was beside himself when he learned of this development. In desperation, he discovered that we had represented the new owner when he bought the building some months earlier, so he called us to ask what was going on. We could not quite believe what had happened when we heard about it. We got on the telex machine and gave our client a quick education on landlord-tenant law here in California. I understand that the garbage service has returned, and the building is back where it was before. The rents did not get doubled and, yes, everybody still has their appliances.

I tell you this true story because it forcefully emphasizes the need to be aware of the fact that when you represent a foreign client, you are dealing with someone whose investment perspective is as alien as he is. When we sat down with this individual and asked him why he did what
he did, we quickly realized that in his home country tenants do not have any rights. They are grateful for any kind of shelter they can find. When they get it, they do not complain. They do not ask anybody to pick up the garbage, and they do not care if the appliances work because they consider themselves lucky to have them at all. From our client’s perspective, the thought that his new tenants in Los Angeles should have even basic sanitation rights went completely against the grain. Because our involvement in this transaction was a limited one, it never occurred to us that he did not recognize the value of keeping a rental unit in good condition in the United States. As you can see, you can never take the assumption too lightly that foreign clients have a different perspective on things than we do.

For those of you who have yet to represent a foreign client, I am not sure I can say anything this morning that will keep you completely out of trouble. I would, however, like to share a few thoughts that I have developed to minimize the chance that something will go wrong. In plain language, I would like to show you how to play the percentages so they do not work against you. When you deal with foreign clients, try to keep five rules firmly in mind.

First of all, when possible, make sure you know who your client really is. As I say this, some of you are probably thinking, "Berwind’s out of his mind. Of course I know who my client is. He is the guy that calls me up on the phone for an appointment and comes in to see me. Right?" Well, about eighty percent of the time the foreigner who walks in the door and sits down with you for a consultation probably will be your actual client. But twenty percent of the time, however, that person will be nothing more than a middleman. That is particularly likely if your real client is a flight capital investor—a foreigner who is worried about the political situation in his home country and wants to get his assets out, so he can get himself out if the situation changes for the worse. Those clients are extremely cautious about disclosing their identity to anyone.

Like all rules, the rule about knowing your client will be broken on occasion. As an example, I have one client whom, to this day, I have never met and have no idea who he really is. The most I could learn from the woman who came in to see me was his nationality. I explained to her that without at least that information, I would not represent him. If I knew his nationality, I would be willing to do some minimal tax planning on the understanding that if something went wrong because I did not know his actual identity, it was going to be her fault rather than mine.
There are at least two reasons why it is important to know your foreign client's identity. The most obvious reason concerns taxes. You do not plan an inward investment for a Chinese investor from Hong Kong the way you plan one for a German investor living in the Federal Republic or a Japanese investor living in Osaka. For one thing, we have an income tax treaty with Germany and Japan but not with Hong Kong. For another, the Japanese and German treaties are quite different from one another, as are the internal tax laws of those countries. You need to know who your client is and where he comes from because the structure of his investment in the United States can be significantly affected by that information. The second reason you need to know who your client is is to screen out possible conflicts of interest. You can get very nervous working with a foreign investor who owns a piece of real estate through a Netherlands Antilles corporation (NV) that another NV, anonymously owned, wants to buy. Before the sale goes through, you will almost certainly know if your firm is representing both NVs, but it is embarrassing to enter into a transaction only to discover that you have to back out of it because of such a conflict of interest. Therefore rule number one is to determine who the real client is.

Rule number two: when you determine who your client is, make sure he knows the extent of your role as an attorney acting on his behalf. In some foreign countries, lawyers do not give business or tax advice; they simply draft documents. They sit in a small room with a lightbulb overhead that is about to go out and just write documents. Clients who come from those countries often assume that that is all lawyers do. It is only natural for them to expect the same kind of service from you. If instead you sit down with the client and start offering tax advice or general business advice, they will get confused about what you are supposed to be doing. If they get confused about that, they will be even more confused about the bill they get for your services. So a word to the wise: explain to the clients at the outset what it is you will be doing on their behalf.

In this same light, make sure your foreign clients understand that what they tell you in confidence is protected by the attorney-client privilege. Many foreigners have no idea that the privilege exists. Again, it is particularly important that flight capital investors understand this. Without the absolute assurance that what they tell you in confidence will go no further than the office you are meeting in, they will not tell you everything you may need to know to correctly advise them. As all of you know, the best advice in the world may be absolutely worthless if it is based on the wrong facts. You should also be sensitive to the fact
that foreign clients frequently do not appreciate their need to work with U.S. accountants and bankers to implement their business plan. Be prepared to explain what each of these advisors will do and how each of them expects to be compensated. Again, your purpose here is to take away the element of surprise.

Rule number three: in many foreign countries, particularly in Europe, paying the full amount of income taxes owed simply is not done. As hard as this may be to believe, taxes are not viewed as a serious legal obligation. In fact, with all the talk lately about the underground economy in this country, it seems the disease may be spreading. Some Europeans I have met probably have fifteen sets of accounting books: one set for themselves (that is the real set), one for their wife, one for their lover, one for their partner, one for the tax authorities, etc., and probably one just for you if you happen to ask for it. You would not believe the "flexible accounting" that some people use when they compute their taxable income. As a practical matter, it does not seem important because most European nations do not rely on income taxes to raise the bulk of their revenue. They rely instead on value-added taxes. What happens in Europe if you are caught using such creative accounting? Not to worry. You sit down with the local inspector of taxes, get a slap on the wrist, pay a little fine, then everyone goes home happy. You must explain to your client that over here the difference between tax avoidance and tax evasion is about ten years in federal prison. In the United States, it is a felony to evade taxes and, in some instances, you must beat that fact into your foreign client’s head because he will not believe it. I have explained this point to a few of my clients and watched them come into my office the very next day talking about using dummy invoices and bank accounts and the other evasive systems they use in their home country. You must be persistent in explaining to your clients that, in this country at least, filing a true and accurate tax return is a serious item of business.

Rule number four: you need to explain to foreign clients at the start of your relationship that the legal system in the United States is extremely fragmented. Many foreigners still think the Wild West exists here and that there are no restrictions on what they can do. When they decide to develop a piece of real estate, they want to break ground tomorrow. You and I both know it is not always that easy. In this country, governmental power is carved up in two basic ways. First of all, power is split between the federal government and each of the fifty states. Secondly, both governments separate their executive, judicial, and legislative functions in such a way that they are quite independent
of one another. Getting this point across to your client will help him understand why you may have to consult several different laws or file reports with various administrative agencies before plunging ahead with a particular project. If you do not explain in advance the way the system works in this country, your client is apt to get irritated with what he perceives as your unreasonable delay in doing what he thinks should be done very quickly. Furthermore, I might point out that some foreign clients will interpret your delays with administrative red tape as an invitation to grease the skids with an under-the-table payment. This is another one of those cross-cultural problems to which you need to be alert. As I mentioned earlier, commercial bribery is a common part of doing business in many foreign countries, but not here in the United States. Again, it is important to educate your client to the way things work here and get him to change his frame of reference from doing business in his home country to doing business in the United States. This is, of course, why he is seeing you in the first place.

Rule number five: inform your foreign client about the difficult subject of disclosure laws. The two major disclosure laws are found in 15 C.F.R. § 806 (1977) and 7 C.F.R. § 781 (1979). Until 1977, there were no major disclosure rules that affected foreign investments in the United States. Suddenly, however, Congress woke up and realized that there was a substantial amount of foreign money coming into this country, and they did not have the foggiest idea where it was coming from or why. So legislation was passed requiring the Departments of Commerce and Agriculture to collect detailed information concerning inward investments. You need to talk with your foreign clients about these laws because many of the clients, particularly flight capital investors, are extremely wary about disclosing what they are doing. They worry about the possibility that governments share information. Unfortunately, whether foreigners like it or not, there are now mandatory disclosure laws on the books, and the penalty for noncompliance is severe. When you work with these clients, it is important to explain those laws to them and make sure the laws are understood.

Before getting into the heart of my subject, namely a survey of the tax problems that face inward investors, let me take just a minute to talk about supplementary reference material. Almost invariably, when someone starts representing a foreign client, one of the first things they do is look around for references to brush up on legal issues and spot ideas to think about for planning purposes. There are three good reference sources that I would like to call to your attention. First, the District of Columbia Bar has put together a wonderful practice handbook
called *Foreign Investments in the United States—1980 Legal Issues and Techniques*; the book can be ordered by writing to The District of Columbia Bar, 1426 “H” Street, N.W., Eighth Floor, Washington, D.C. 20005. In addition to containing some useful discussions of our tax, securities, antitrust, and immigration laws as they pertain to inward investments, the book contains a useful survey of the state law limitations that affect these investments. Second, the American Bar Association has put together a hardbound book called *ABA Committee on Securities, Corporations, Banking & Business Law, A Guide to Foreign Investment Under United States Law* (1979). Overall, this is a fairly useful book except that half of it is an out-of-date appendix. If you concentrate on the first half of the book, however, you will find some useful planning ideas. Finally, the most helpful reference material that I have seen is a course handbook put out by the Practising Law Institute (PLI). For the last five years, PLI has put on an annual program about foreign investment in the United States, and the speaker outlines in these books are extremely useful. They provide a good way to keep current with developments in this constantly changing area. If you are unable to get either of these sources at a law library, you can write the Practising Law Institute, 810 Seventh Avenue, New York, New York 10019, and order the particular books you want. With those general comments behind me, let me turn to a survey of the tax problems that face inward investors.

**INCOME TAX PLANNING FOR FOREIGN CLIENTS**

In preparation for this morning’s meeting, I tried to pencil out a list of issues that might be useful for you to think about when representing a foreign client. When I put the list together, however, I discovered that it did not make a lot of sense in the context of my own practice because the issues that I catalogued did not apply uniformly across my client base. If my practice can serve as a guide, the universe of inward investors can be split into two groups. Into one group we can put the high-net-worth individual looking for a specific investment opportunity in the United States. Into the other group we have the foreign corporate client attempting to enter the U.S. market. The company may be trying to expand its own operation in this country, or it may be in search of a good domestic acquisition target.

With respect to the first group of clients, the high-net-worth individuals, we generally do two things for them. First, we try to plan their investments in this country to keep taxes down to an absolute minimum. Second, we “plan” their personal presence in this country so
they do not get caught up in the full reach of our tax laws. U.S. citizens and resident aliens are generally taxed by the Internal Revenue Service (IRS) on their worldwide income; the IRS does not care if income is earned in Tucson, Arizona, or in Timbuktu. Wherever it is earned, the income must be declared, and more likely than not, tax must be paid on it. Nonresident aliens, on the other hand, can only be taxed by this country if their income has a certain connection with the United States. By this I mean that their income must either come from sources within the United States, as determined under sections 861-864 of the Internal Revenue Code, or be effectively connected with a U.S. trade or business. If the income is not connected in either way, U.S. tax is avoided. Quite obviously, then, an alien individual’s resident or nonresident status is extremely important to ascertain.

In addition, it is important to watch the amount of time a nonresident alien spends in this country, because this can affect his exposure to tax on certain capital gains. One of the problems we encounter with some of our high-net-worth individual clients is that they not only like to invest in this country, they like to visit here as well. One by one they start coming over. Soon they bring along their wives, and they discover Rodeo Drive in Beverly Hills. Then they discover Las Vegas. Before long they decide that they are having so much fun over here, they will buy a condominium. Then Burt the parakeet starts getting lonely back in their home country so they bring him over. Then they find out that the schools over here are good so they enroll their kids here. Before long, they are spending more time over here than they are in their home country. What you have on this set of facts—and it is not atypical—is a real litigation breeder with the IRS. As a foreign individual begins to spend more of his time in the United States, he is increasing the odds of becoming a U.S. resident for tax purposes. This, of course, means being taxed on his worldwide income, not just the income he derives from making investments in this country. Even if resident status can be avoided, prolonged visits in the U.S. may render certain capital gains subject to tax. Because in many instances there is a lot of money involved, the stakes here can be extremely high. One of the things we do with our individual foreign clients is to explain their tax status as either a resident or nonresident. If they are a nonresident, and they usually are when we first see them, we go on to explain the things to watch out for to avoid an inadvertent change of status. Finally, we give them this advice in writing. As many of you know, clients always seem to have short memories when something goes wrong. By putting our advice in writing, they can not come back to us six months later
and say we never told them so. The first thing we do is to plan and control the personal tax status of individual clients in this country.

The second thing we do with these clients is to plan their investments in this country to keep taxes to a minimum. As some of you know, one of the hottest investments for foreigners has been real estate. There are two reasons for this. First, over the past ten years, property values have soared in this country. Second, at least until 1980, foreigners could usually structure a real estate investment so that they could get out of it and not pay any tax in the U.S. It was a wonderful situation. Our foreign clients were getting rich, we were getting rich on the fee income, and a few foreign countries—most notably the Netherlands Antilles—had a whole industry built around managing these investments. If all of this was making our foreign clients deliriously happy, it was driving a lot of U.S. citizens right up the wall. In California, for example, foreign investors were simply adding more fuel to an already frenzied real estate market. With mortgage money drying up and fears that U.S. farmlands were coming under foreign control, the political pressure finally became so great that in 1980 Congress enacted the Foreign Investment in Real Property Tax Act, which we generally refer to as FIRPTA. You will find most of this legislation in section 897 of the Internal Revenue Code.

As often happens, a law that is quickly drafted tends to either overshoot or undershoot the intended mark, and it turned out that FIRPTA was no exception. While a lot of folks thought that the real estate game for foreign clients was finished after FIRPTA became law, some of us were able to devise holding structures that arguably could skirt the statutory language and continue to allow certain investors to get out of a real estate project in this country without paying any U.S. tax. I am sorry to report that word of this got back to Washington and as part of the Economic Recovery Tax Act, Congress did a little fine-tuning with FIRPTA, so the door has been closed a bit tighter.

When we shift our focus from the high-net-worth individual to the foreign corporate client trying to expand its business into the United States, we generally move away from personal tax planning issues (although residency problems still arise for foreign executives and personnel relocated to the U.S.). We focus now on how to structure the client’s business operations in the United States to keep taxes at a minimum. One of the things we have to keep in mind here is that we are often working with the tax laws of at least two countries. Quite obviously, it does not do any good to come up with a tax plan that works in the United States but leaves the client with a complete disaster in his
home country. We basically approach this problem on both a macro and a micro level. On the macro level, we ask ourselves whether the client should be doing business in the United States through a branch or subsidiary. If we conclude that a subsidiary is more appropriate, we then have the ancillary problems of determining whether it should be a domestic or a foreign corporation and, in either event, whether we ought to have a chain of holding companies underneath it. In working through these problems, we look at the possible benefits from filing a consolidated return with the IRS, as well as at the lower withholding taxes that may be available if dividends and interest can be routed through an offshore holding company that can claim the benefit of a tax treaty with the United States; however, the planning possibilities here may be significantly curtailed as the United States renegotiates its treaty commitments with other countries.

Once we have done this planning at the macro level, we then fine tune our analysis by looking at a number of micro issues. We are going to take up two of these issues this morning. The first one concerns the general question of financing. Those of you who have had a corporate tax course should all have fond memories of section 385 of the Internal Revenue Code. One of the major problems in our tax law has been finding a way to distinguish corporate debt from equity. Many of our foreign clients, if given the choice, would capitalize their U.S. companies with as much debt as possible because interest payments escape the double tax that normally attends a payment of dividends. In addition, if the interest is being routed through a treaty jurisdiction company, U.S. withholding taxes will normally be lower than the applicable withholding tax on dividends. For these reasons, foreign clients have a tremendous incentive to label everything they put into a company as debt. Obviously, everything a shareholder puts into a corporation cannot be debt. Congress recognized that fact, and they added section 385 to the Code to try to sort this difficult problem out. Unfortunately, section 385 does not say very much except that Congress wanted the debt/equity problem straightened out and that the IRS would have to write some regulations to do it. To no one’s surprise, nothing happened for a long, long time. It is perhaps a fitting comment to tell you that the debt/equity issue produced what is probably the world’s longest law review article written by a single author. The author in question is William Plumb, and the article was The Federal Income Tax Significance of Foreign Debt, 26 Tax L. Rev. 369 (1971). It covered 279 pages and had an incredible 1,579 footnotes. If you were able to make your way through the whole thing, you unfortunately found at the end that
Mr. Plumb was not sure he could always distinguish debt from equity either. It is really a problem.

In 1979, after years of silence, a relatively rare technical advice memorandum (IRS Letter Ruling No. 7906001 (1979)) was issued by the National Office, which went into some detail about the tax status of a particular shareholder's investment in a corporation. Some thought this might be a signal that regulations were being prepared in Washington. Sure enough, not one year later, the Carter Administration issued the first set of proposed regulations under section 385. As of the date of this symposium, these regulations have been revised several times, but there is still not a final set on the books.

The second micro issue we will discuss this morning is a problem that often arises in connection with foreign clients who export to the United States; that is the question of when a foreign corporation is considered to be engaged in a U.S. trade or business. If the corporation comes from a jurisdiction with which we have a tax treaty, the question is a little more complex, i.e., when is the client engaged in a trade or business through a permanent establishment? We try, when possible, to set up the client's export operations in such a way that they are doing business in this country without having a permanent establishment so that their business profits will not be taxed in the U.S. Unfortunately, as you will see shortly, that is much easier said than done.