Hastings International and Comparative Law Review

Volume 5
Number 3 *Spring 1982*

Article 3

1-1-1982

An Overview of Inbound Foreign Investment

Michael W. Berwind

An Overview of Inbound Foreign Investment

By MICHAEL W. BERWIND*

A.B., Colorado College, 1968; J.D., University of California, Hastings College of the Law, 1972; LL.M., New York University, 1973; Partner, Graham & James, San Francisco.

I. INTRODUCTION

A. During the 1970's, the level of foreign direct investment in the United States more than tripled, reaching an estimated $48.5 billion by 1979.

B. A variety of factors encouraged this growth.

1. The United States is one of the most stable nations in the world, giving foreigners the confidence that their inward investments which are here today will be here tomorrow.
2. European investors are increasingly worried about the growing militancy of labor, while Japanese firms are anxious to protect themselves against the increasing pressure to restrict their exports to the United States.
3. In contrast to the situation Americans often face overseas (*e.g.*, in Mexico), American laws are generally receptive to foreign investment. Note, however, that certain investments pertaining to agriculture, national defense, or the public welfare may be off limits to foreigners. *See generally* American Bar Association, Section of Corporation, Banking and Business Law, Committee to Study Foreign Investment in the United States, *A Guide to Foreign Investment under United States Law* 157-229 (1979); District of Columbia Bar, *Foreign Investment in the United States 1980* (1980).

* This outline was prepared for Mr. Berwind's presentation and was provided to all attendees.

II. SPECIAL PROBLEMS IN REPRESENTING A FOREIGN CLIENT

A. One of the mistakes commonly made by attorneys who infrequently deal with foreigners is to assume that representing a foreign client investing or doing business in the United States is no different from representing a domestic client. This assumption is dangerously inaccurate for two reasons. First, many laws in the United States (including the U.S. Constitution) apply unequally to residents and nonresidents. *See, e.g.*, *Johnson v. Eisentrager*, 339 U.S. 763, 769 (1950). Second, a foreign client nearly always comes from a cultural and business environment that is different from our own. Since giving good legal advice depends on the ability to communicate with clients, you need to be sensitive to these differences to be certain that your client *understands* the advice he is receiving.

B. Some thoughts for doing battle with Murphy's Law

1. Make sure that you know who your client really is. Many foreign investors (particularly "flight capital" investors) approach U.S. advisors through the use of middlemen. It is of the utmost importance that you determine both the identity and nationality of your client at the earliest possible time. This information can affect the structure of the inward investment, determine the person (or entity) in favor of whom the attorney-client privilege runs, and uncover potential conflicts of interest.
2. Make sure that your client understands your role in advising him. Many foreigners are not used to receiving tax and business advice from an attorney. In addition, be alert to the fact that your client may need to consult with accountants and bankers to fully implement his business or investment program in the United States. You should be prepared to explain the services that each member of the advisory team will perform and the manner in which each advisor expects to be compensated.
3. Make sure your client understands that your confidential discussions are protected by the attorney-client privilege. Many foreigners are wary of disclosing confidential information to anyone (including professionals) whom they do not know.

4. In many foreign countries (particularly in Europe) paying income taxes is regarded as something of a sporting event. Since these countries do not rely on such taxes to produce the bulk of their revenue, they rarely make a serious effort to enforce those laws. The United States, however, depends heavily on income taxes to meet its spending needs. Consequently, your client needs to understand that failing to file a true and accurate return with the Internal Revenue Service (IRS) can result in criminal penalties and property seizures.
5. Many foreign clients are unaccustomed to the fragmentation of governmental power in this country. Not only is power shared between the federal government and the fifty states, but both governmental bodies separate their executive, legislative, and judicial functions. Explaining this shared system of governing helps your client understand why you need to consult a number of laws or deal with a number of administrative agencies in connection with the client's business or investment activity in this country.
6. Recent legislation has increased the need to make certain disclosures to the federal government concerning inward investments. *See, e.g.*, The International Investment Survey Act of 1976, 22 U.S.C. §§ 3101-3108 (1979 & Supp. 1982); The Agricultural Foreign Investment Disclosure Act of 1978, 7 U.S.C. §§ 3501-3508 (Supp. 1982). Since many inward investors desire anonymity for a variety of legitimate reasons, these disclosure rules need to be carefully explained to avoid incurring penalties and other problems.

III. SURVEY OF TAX ISSUES AFFECTING INWARD INVESTMENTS

A. Residency. For foreign individuals, a critical tax issue is establishing proper residency status under the Internal Revenue Code. The issue of one's residency arises not only for the inward investor spending substantial time in this country, but also for foreign executives temporarily reassigned to duty in the United States. *See generally* Langer, *When Does*

A Nonresident Alien Become A Resident For U.S. Tax Purposes? 44 J. Tax'n 220 (1976).

1. Nonresident aliens are taxable only on income which is derived from sources within the United States or effectively connected with a U.S. trade or business. *See* I.R.C. §§ 871, 872 (1967 & Supp. 1982).
2. U.S. citizens and resident aliens are taxable on their worldwide income. *See Cook v. Tait*, 265 U.S. 47 (1924) (rejecting a constitutional challenge to this sweeping claim of jurisdiction).
3. Treas. Reg. § 1.871-2(a) defines a nonresident alien to mean an individual whose residence is not within the United States *and* who is not a U.S. citizen. *See also* Treas. Reg. § 1.871-2(b) (1957) (which defines the term "residence").
   a. Note that residence is not equivalent to domicile. A person may be a resident for income tax purposes even though he/she does not intend to reside permanently in the United States and has a domicile elsewhere. *See Maclean v. Commissioner*, 73 T.C. 1045 (1980); *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).
   b. Note also that a person's status under the immigration laws is not determinative of his/her resident status for income tax purposes. *See* Rev. Rul. 58-144, 1958-1 C.B. 260. However, an alien whose stay in this country is limited to a definite period by the immigration laws is not a resident in the absence of "exceptional circumstances." *See* Treas. Reg. § 1.871-2(b) (1957).
   c. For a useful discussion of the tax planning that can be done for an inbound investor intending to become a U.S. resident, see Cates, *Pre-Immigration Tax Planning for the U.S.-Bound Nonresident Alien*, U.S. Taxation of International Operations (P-H) ¶ 15,508 (Apr. 14, 1982).
4. If a foreign investor becomes *domiciled* in the United States, he or she will also become subject to the full reach of our gift and estate tax laws. *See generally* Treas. Reg. § 20.0-1, T.D. 7665, 45 Fed. Reg. 6089. For a com-

parison of the meaning of "residence" for income and estate tax purposes, see *Estate of Jan Willem Nienhuys*, 17 T.C. 1149, 1161 (1952), *acq.*, 1952-1 C.B. 3.

B. Foreign investments in U.S. real estate. Until recently, this was one of the hottest investments for foreigners because of the rapid appreciation of real estate in this country and the fact that these investments could often be structured to avoid any federal income tax when they were terminated.

1. The Foreign Investment in Real Property Tax Act (FIRPTA) (I.R.C. § 897 (Supp. 1982)) has curtailed many of the tax planning opportunities in this area. See the outline by Richard Eigenbrode for additional material on FIRPTA.

2. Note that state law may significantly affect the ability of foreigners to invest in U.S. real estate. *See generally 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) (updating a similar article appearing in 14 Real Prop., Prob. & Tr. J. 1 (1979)). *The failure to review state law before making an inward investment in U.S. real estate is an open invitation to a malpractice suit.*

C. Branch vs. subsidiary. Foreign corporations planning to engage in a U.S. trade or business need to carefully consider whether the business should be conducted as a branch or through a subsidiary corporation. If the use of a subsidiary is indicated, an ancillary problem is determining whether the subsidiary should be domestic or foreign and whether a U.S. and/or foreign holding company is advantageous to the overall tax plan. Analyzing this problem requires an evaluation of the U.S. tax burden *and* the foreign investor's home country tax situation. Where the foreign investor is subject to little or no tax abroad, most of the planning will involve minimizing U.S. taxes.

1. Nonresident alien individuals and foreign corporations doing business in the United States through a branch are subject to tax at regular U.S. progressive rates on their net income which is "effectively connected" with the conduct of such business. I.R.C. §§ 871(b) and 882(a) (1967 & Supp. 1982). In computing this tax, the usual

deductions are allowed but only to the extent that they are connected with the taxpayer's business income. *See id.* §§ 873(a), 882(c)(1)(A). Except for compensation paid to a nonresident alien for personal services, income that is effectively connected with a U.S. trade or business is not subject to withholding.

2. Dividends paid by a domestic corporation to its foreign shareholders will generally be subject to a 30% withholding tax unless a lower withholding rate is prescribed by treaty. *See id.* §§ 861(a)(2)(A), 1441, 1442. Dividends paid by a foreign corporation doing business in the United States to its foreign shareholders may also be subject to U.S. withholding tax. *See id.* §§ 861(a)(2)(B)-(C), 1441, 1442.

D. Treaty shopping. Many foreigners structure their business and investment activity in the United States through the use of holding companies created in countries having a tax treaty with the United States (*e.g.*, the Netherlands, the Netherlands Antilles, or the British Virgin Islands). *See generally* Vogel, Bernstein & Nitsche, *Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious A Rival to the Netherlands Antilles Island Paradise?* 34 Tax L. Rev. 321 (1979). The Treasury Department has recently announced that future U.S. income tax treaties will contain provisions to assure that source basis tax benefits are not improperly obtained by residents of third countries. *See* Treasury Dep't News Release R-546 (Dec. 23, 1981).

1. Tax treaties prescribe the needed physical presence for business income to be taxed by the United States. In general, our treaties provide that business income ("industrial and commercial profits") can be taxed only if the foreign entity or individual maintains a "permanent establishment" in the United States.
2. Treaties also generally lower the U.S. withholding tax on dividends, interest, and royalties.
3. Treaties may provide for "competent authority" relief in the case of severe instances of double taxation.
4. For a useful discussion of tax treaties, see *1977 Tax Treaties and Competent Authority*, 5 N.Y.U. Int'l Inst. on

Tax and Bus. Plan. (1977); J. Bischel, *Income Tax Treaties* (PLI 1978).

5. Note that tax treaties generally have no effect on a state's ability to tax inward investments.

E. The debt-equity conundrum. A commonly recurring question facing inward investors is how to finance their business conducted in the United States. For tax reasons, foreigners often prefer to capitalize their companies with debt rather than equity. One of the most troublesome tax issues is the current status of a corporate instrument as either debt or equity. The proposed section 385 regulations will play a major role in policing this area. See the outline by Steven Cohen for additional material on these regulations.

F. Transfer pricing problems. Foreigners doing business in the United States often seek to reduce taxes by artificially arranging their affairs to minimize the income subject to taxation by the IRS.

1. Section 482 of the Internal Revenue Code gives the IRS authority to place the dealings between related parties on an arm's-length basis. For an excellent discussion of this area, see Fuller, *Section 482 Revisited*, 31 Tax L. Rev. 475 (1976).

2. California has a highly controversial approach to the problem of transfer pricing. In general, related entities are required to file a "combined report" with the state if one or more of them does business in the state. Because combined reports must be filed on a basis consistent with generally accepted accounting principles, compliance can be an administrative nightmare for inward investors. The major tests for determining whether a business is unitary are the "three unities test" announced in *Butler Bros. v. McColgan*, 17 Cal. 2d 664 (1941), *aff'd*, 315 U.S. 501 (1942), and the "contribution and dependency test" announced in *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472 (1947).

   a. The propriety of forcing domestic and foreign affiliates to report on a combined basis is presently before the U.S. Supreme Court. *See Chicago Bridge & Iron Co. v. Caterpillar Tractor*, Doc. No. 81-349.

   b. The California Assembly has recently approved a bill that would limit the state's ability to use worldwide combined reporting in certain instances. Note also that H.R. 1983 and its Senate companion bill S. 655, if passed, would prevent any state from taking into account the income of a related foreign corporation when applying their income tax to a company.

G. Foreign exchange gains and losses. Nonresident alien individuals and foreign corporations with a U.S. branch may incur foreign exchange gains and losses in connection with their U.S. trade or business. Although the tax treatment of these gains and losses is not completely settled, the Treasury Department has released a discussion draft concerning this subject. *See* 8010 CCH Std. Fed. Tax Rep. ¶ 6827G. The report is commented on by the ABA Tax Section in 36 Tax L. Rev. 425 (1981). *See also* Johnson & Marino, *The U.S. Taxation of Foreign Exchange Gains and Losses: An Analysis of the Treasury Discussion Draft*, 59 Taxes 1031 (1981).