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Significant tax benefits can be achieved by United States taxpayers engaged in foreign business operations or making investments abroad by properly structuring such operations or investments. This applies to both individual and corporate taxpayers. The principal tax advantage accomplished by the proper structuring of foreign business operations and investments is the *deferral* of U.S. tax liability until the income derived by the foreign operations is *repatriated* to the U.S. taxpayer sometime in the future. Normally, the foreign entity used to conduct the operations would not be subject to U.S. tax. There would thus be only one single U.S. tax liability imposed on the U.S. shareholder-taxpayer when he receives, actually or constructively, the income generated by the foreign operations or investments. Sometimes the U.S. taxpayer can also hope for capital gains treatment on certain kinds of repatriations (at a maximum rate of twenty percent for individuals and twenty-eight percent for corporations), particularly when the controlled foreign corporation (CFC) status can be avoided. I.R.C. § 957 (1982). Such favorable repatriations include liquidating distributions, complete redemption of the U.S. shareholder's stock interest in the foreign corporation, or sale or exchange of its stock. Finally, in the case of certain business operations in Puerto Rico, all U.S. taxes (corporate and individual) can be avoided.

I. CHOICE OF ENTITY

In order to accomplish these tax benefits, particularly the deferral of U.S. tax liability, it is generally necessary for the U.S. taxpayer to use a foreign corporation to conduct the foreign business operations or to

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

make the foreign investments, with the exception of certain business operations in Puerto Rico.

If the U.S. taxpayer is an individual and would engage in the foreign operations directly or would make the investment directly, he would be subject to U.S. tax on the income derived from such operations or investments since a U.S. taxpayer is always subject to U.S. tax on his worldwide income. The same result would apply if he would establish a partnership, whether domestic or foreign, since a U.S. taxpayer has to report his pro rata share of partnership income on his individual U.S. income tax return. Normally, it would not be advisable for him to use a U.S. corporation for the foreign operations or investments since this corporation, too, would be subject to U.S. corporate tax on its worldwide income. Thus, if the individual U.S. taxpayer expects that the foreign operations will generate significant income, he would have to establish a foreign corporation to conduct such operations or to make such investments in order to attain favorable tax benefits.

Of course, this does not mean that the use of some other entity would not be beneficial under certain circumstances. For example, if it is expected that the foreign operations will generate substantial losses for some time, it might be preferable to use a partnership form for the venture since this would enable the partners to claim their pro rata share of losses.

Similar considerations would apply to a U.S. corporate taxpayer since such taxpayer would also have to operate abroad through a foreign corporation in order to achieve the tax deferral and other tax benefits (unless the business operations are in Puerto Rico). Thus, the principal vehicle for establishing foreign operations or making foreign investments is normally a foreign corporation.

To accomplish the deferral of U.S. taxes, the foreign corporation should not be engaged in a trade or business in the U.S. and preferably should have no income from U.S. sources. In such a case, the foreign corporation would not be subject to U.S. corporate taxes at any time. I.R.C. §§ 881 and 882. Thus, this would solve the problem on the *corporate level*.

In addition, care should be taken to avoid U.S. taxation on the *shareholder level*. In this respect, the U.S. taxpayer must face two formidable obstacles, namely the foreign personal holding company provisions, I.R.C. §§ 551-558, and the Subpart F income provisions. I.R.C. §§ 951-964. If either of these provisions applies, the net result is that the pro rata share of the income of the foreign corporation is includable in the gross income of the U.S. shareholder even though it is not actually distributed as dividends by the foreign corporation.

The foreign personal holding company income provisions will apply if more than fifty percent of the value of the outstanding stock of the foreign corporation is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the U.S. and if at least sixty percent (fifty percent after the first year) of its gross income consists of foreign personal holding company income such as dividends, interest, royalties, gains derived from the sale or exchange of stock or securities, gains derived from commodity futures transactions, etc. I.R.C. §§ 551 and 552.

The Subpart F income provisions apply if the foreign corporation is a CFC and derives certain "tainted" kinds of income, including such passive income as dividends, interest, or gain realized from the sale of stock or securities. In order for the foreign corporation to be considered a CFC, more than fifty percent of its voting stock must be held by U.S. shareholders, *i.e.*, U.S. persons each owning, or considered owning, at least ten percent of the foreign corporation's voting stock. I.R.C. §§ 957 and 951(b).

The Subpart F income provisions come into play as soon as at least ten percent of the CFC's gross income consists of foreign base company income. I.R.C. § 954(b)(3)(A). Thus, these provisions often make the income realized by the CFC taxable in the hands of the U.S. shareholder on a current basis even though the foreign personal holding company income provisions would not yet apply (since such provisions require that at least sixty percent of the corporation's gross income would consist of tainted income). In addition, if the CFC's foreign base company income exceeds seventy percent of its gross income, its entire gross income is treated as Subpart F income and is thus subject to U.S. income tax in the hands of its U.S. shareholders on a current basis. I.R.C. § 954(b)(3)(B).

In effect, the foreign personal holding company income provisions and the Subpart F income provisions define the various types of income with respect to which the tax laws are not willing to allow deferral of U.S. taxes. It is thus necessary in each case to consult these provisions to determine (1) whether a particular proposed type of income is covered by them and thus is subject to U.S. tax on current basis in the hands of the foreign corporation's U.S. shareholders, or (2) whether the type of income would escape these provisions and thus accomplish the tax deferral.

As a general rule, "substantial" foreign business operations, such as manufacturing or trading with unrelated parties, do not generate tainted income and thus escape the immediate, direct taxation in the hands of the foreign corporation's U.S. shareholders. In addition, if at least fifty percent of the stock of the foreign corporation is held by foreigners, normally neither of the mentioned two sets of rules is applicable, and again the income realized by the foreign corporation would be entitled to "tax deferral."

If it appears that the tax deferral could be accomplished, and thus no U.S. taxes would be imposed on the foreign profits on current basis, it is then necessary to select an appropriate foreign country in which to incorporate in order to eliminate or reduce any foreign taxes on the same income. The search is then on for a suitable "tax haven" country. The choice of the particular foreign jurisdiction as a tax haven may depend on several factors, however, including the nature of the proposed operations, provisions of U.S. tax laws* and business considerations. Therefore, no single formula is available which would suggest, for example, that a country such as the Cayman Islands or the Bahamas should be used as the country of incorporation in each case. To the contrary, the situation must be carefully studied with respect to each proposed foreign operation, and the country of incorporation must be selected on the basis of all of the mentioned considerations.

II. FOREIGN MANUFACTURING OPERATIONS

The U.S. taxpayer, individual or corporate, can establish a foreign corporation to engage in manufacturing operations abroad. As a general rule, the income of such foreign corporation would not be subject to U.S. corporate tax. Manufacturing income is not listed among the tainted kinds of income either in the foreign personal holding company

* For example, section 954(e), governing foreign "service" operations, may require that the CFC be incorporated in the country of operations.

income provisions or in the Subpart F income provisions. Thus, substantial tax deferral could be accomplished in this manner.

Since foreign manufacturing operations usually result in complete deferral of U.S. corporate taxes, it becomes important to assure that profits will not be subject to high taxes in the foreign country of operations. Many foreign countries offer tax exemption programs which are quite helpful in this connection. Leading countries in this respect are Ireland, Singapore, South Korea, the Philippines, Taiwan, and the Dominican Republic.

In most cases, (*e.g.*, in the case of Ireland), the laws of the foreign country do not require that the tax-exempt local operations be conducted by a locally incorporated corporation. Thus, the taxpayer has the choice between establishing a corporation in the country of operations or in some tax haven jurisdiction. Normally, it is preferable to incorporate in a country which does not have any income or corporate taxes at all such as the Cayman Islands, the Bahamas, or Bermuda. The fact that the corporation is formed in a country which is different from the country in which the manufacturing operations are actually conducted will not convert the income into Subpart F income and will have no other adverse tax consequences.

III. MANUFACTURING AND SERVICE OPERATIONS IN PUERTO RICO

Manufacturing and certain other business operations in Puerto Rico present a special case. Puerto Rico, like other U.S. possessions, is treated by the Internal Revenue Code (I.R.C.) as a foreign country. I.R.C. § 7701(a)(4), (5), and (9). The tax benefits derived by Americans from foreign operations therefore apply equally to Puerto Rico. However, Congress intended to favor Puerto Rico particularly; accordingly, it enacted special provisions relating to certain business operations in Puerto Rico which are now contained in section 936 of the I.R.C.

Under these provisions, the U.S. taxpayer, individual or corporate, can establish a U.S. corporation (*e.g.*, a Delaware corporation) to engage in manufacturing or other active business operations in Puerto Rico. Provided that the corporation can satisfy the requirements of section 936, it would be entitled to a possession tax credit, the net effect of which is to eliminate completely the U.S. corporate tax on income derived by such corporation from manufacturing or other active business operations in Puerto Rico.

Normally, the requirements specified in section 936(a) can be satisfied without too much difficulty. The principal requirement is that the section 936 corporation must derive at least eighty percent of its gross income from sources in Puerto Rico. This can be accomplished by passing on the legal title and risk of loss with respect to the products sold by the section 936 corporation to its buyers in Puerto Rico. Also, the section 936 corporation must actually receive its income in Puerto Rico. I.R.C. § 936(b).

If these various requirements are complied with, the corporation is, in effect, completely exempt from U.S. corporate taxes. To match this tax benefit, the Puerto Rican legislature has provided a partial tax exemption program (Puerto Rico Industrial Incentive Act of 1978, Act No. 26 of June 2, 1978) under which corporations engaged in qualifying manufacturing operations in Puerto Rico are subject to a very modest tax burden.* The net result is that by using section 936 corporations, U.S. taxpayers can generate substantial profits from manufacturing and certain other business operations in Puerto Rico at a light tax burden.

In addition, if at least eighty percent of the stock of the section 936 corporation is owned by a U.S. parent corporation, the profits of the section 936 corporation can be repatriated to the parent corporation (in the form of dividends) completely free from any U.S. tax since the parent corporation would be entitled to claim the one-hundred percent dividends-received deduction with respect to such dividends. I.R.C. § 243(b)(1)(C). Finally, if the stock of the section 936 corporation is owned by an individual, he could move to Puerto Rico, become a bona fide resident of Puerto Rico, and then receive all of the accumulated profits of the section 936 corporation, in the form of dividends, completely free from any U.S. income taxes. I.R.C. § 933.

IV. FOREIGN TRADING OPERATIONS

The U.S. taxpayer can establish a foreign corporation to engage in international trading operations, that is, buying and selling products with

* Typically, most tax-exempt corporations pay the Puerto Rican corporate tax (at the maximum rate of forty-five percent) on ten percent of their taxable income during the first five years of operations and on twenty-five percent of taxable income during the next five years of operations.

unrelated suppliers and buyers. As long as such a trading corporation does not distribute the products of a related U.S. person (such as its controlling stockholder) and does not sell the products to such a person, the income realized by the foreign corporation from such business would not be Subpart F income. I.R.C. § 954(d). It is also clear that such income would not constitute foreign personal holding company income. I.R.C. § 553. Thus, the profits could be accumulated in the foreign entity free from U.S. corporate taxes.

When a U.S. entrepreneur decides to establish a foreign sales company, he usually explores with care the country in which such corporation and its operations should be established. There are not too many countries which are suitable for this purpose.

One of the best countries for this purpose is Switzerland where, as long as the Swiss trading company buys from suppliers outside of Switzerland and sells to buyers outside of Switzerland, only twenty-five percent of its income is subject to tax. The effective rate of Swiss taxes then is approximately only ten percent (using a forty percent combined Swiss federal and cantonal tax rate on twenty-five percent of taxable income). Another good jurisdiction, particularly for the Pacific area, is Hong Kong, which imposes a seventeen percent company tax. All or a substantial portion of that tax, however, can often be eliminated by proper planning and particularly by communicating the purchase orders and acceptances (*i.e.*, entering into contracts) outside of Hong Kong. Finally, Panama is also a good jurisdiction for this purpose since a Panamanian company is completely exempt from Panamanian taxes on income derived from such trading operations as long as the goods do not reach Panama. Normally, a trading company should be established in a country which has substantial trading operations rather than in a tax haven country with a strong "paper company" impression such as the Cayman Islands.

It is also important to assure that the foreign trading corporation will not be deemed to be engaged in a trade or business in the U.S., perhaps because of the activities of its principal stockholders in this country.

V. FOREIGN REAL ESTATE DEVELOPMENT AND REAL PROPERTY SALES OPERATIONS

A U.S. entrepreneur can also establish a foreign corporation to engage in real property development abroad. The profit derived from development and sale of real properties abroad does not constitute Subpart F income or foreign personal holding company income, and therefore is not subject to U.S. tax on a current basis. The same applies with respect to gain realized from simply purchasing and selling real properties abroad.

The foreign corporation could be established in any foreign country since it would be engaged in business operations in one or more countries in which the real estate could be developed. Tax haven countries which have no income tax at all, such as the Cayman Islands, the Bahamas, or Bermuda will be favored. The so-called Channel Islands (consisting mainly of Jersey and Guernsey) and Isle of Man also belong in this category because, while they do impose substantial taxes on companies engaged in local business operations, they subject companies conducting business overseas to only nominal annual charges (in the area of 300 pounds). Vanuatu (formerly known as New Hebrides) and Turks and Caicos also belong in this group.

Attention will have to be given in every case to the possibility that the corporation could be established in a foreign country which has a favorable income tax treaty with the country in which the real estate development is conducted. For example, if the real estate development operations are in the United Kingdom, the American entrepreneur may find a Netherlands Antilles (N.A.) corporation useful since the application of the income tax treaty between the N.A. and the United Kingdom could in certain instances involving shorter projects (not more than twelve months) eliminate U.K. taxes which otherwise might be imposed on the gain realized from such development projects.

VI. FOREIGN SERVICE OPERATIONS

If the U.S. entrepreneur is interested in establishing a foreign service (technical, engineering, architectural, etc.) operation, preference should be given to establishing the corporation in the foreign country in which the services will actually be performed. This assures that the income derived by such foreign corporation is not Subpart F income. Section 954(e)(2) makes it clear that such income will not be considered Subpart F income if the services are performed in the country in which the foreign corporation has been formed. Again Hong Kong, Panama, or the Bahamas are ideal jurisdictions for this sort of operation. Income derived from such operations would not normally be foreign personal holding company income either. I.R.C. § 553(a)(5).

VII. FOREIGN BANKING BUSINESS

A U.S. person could establish a foreign corporation to act as a foreign bank. Income derived by the banking, financing, or similar business of such a foreign bank does not consitute Subpart F income. I.R.C. § 954(c)(3)(B). The regulations state that such banking activities may include receiving deposits from the public, making loans to the public, purchasing and discounting receivables, and acting as an underwriter. Treas. Reg. § 1.954-2(d)(2)(ii). They add that as long as the foreign corporation derives more than fifty percent of its entire gross income from such activities, it will be treated as primarily engaged in banking business.

In addition, it may be necessary to assure that the foreign bank will not be treated as foreign personal holding company under section 551. Section 552(b)(2) provides, in effect, that U.S. shareholders of a foreign banking corporation do not have to include their share of undistributed foreign personal holding company income in their own income if the corporation is organized and is doing business under the banking and credit laws of a foreign country. This fact must be confirmed by an annual certification which can be obtained from the Internal Revenue Service (from the Director of the Office of International Operations) based on applications filed annually with the income tax returns of the U.S. shareholders. Treas. Reg. §§ 1.552-4 and 1.552-5.

Insofar as foreign laws governing banks are concerned, until a few years ago many foreign countries allowed the establishment of banks without minimum capital requirements and other safeguards. This has been changed, however, and even the most liberal countries, such as the Bahamas and the Cayman Islands now require some reasonable substance (including a minimum capital of a few hundred thousand dollars) before the government will license the bank. The Bahamas and the Cayman Islands continue to be the best jurisdictions in which to establish such banks, although consideration should also be given to Montserrat.

VIII. PROBLEMS CONNECTED WITH RETENTION AND INVESTMENT OF ACCUMULATED PROFITS BY FOREIGN CORPORATIONS

Even if the structuring of foreign operations accomplishes the tax deferral, additional problems arise in connection with the handling of the funds accumulated by the foreign corporation. Of course, the foreign corporation could not distribute such funds to its U.S. shareholder since they would then become taxable in the hands of the shareholder as dividends. Thus, the funds might become effectively "locked in" at the foreign corporation.

If a CFC makes an investment in U.S. property, this has approximately the same result as the distribution of dividends to its shareholders. I.R.C. § 956. Therefore, the CFC should avoid making such investments in U.S. property. A loan to the U.S. shareholder or to any other U.S. person would constitute an investment in U.S. property, and therefore it should be carefully avoided.

Finally, upon liquidation of a CFC or the sale of its stock, the shareholders realize ordinary income (rather than capital gain) to the extent of the accumulated earnings and profits of the CFC. I.R.C. § 1248. Within the limitations specified in section 904, they are entitled to a credit for all foreign income taxes, including corporate taxes paid by the foreign corporation to foreign governments.

Thus, in order to avoid subjecting its income to U.S. taxes, the foreign corporation is usually compelled to accumulate its funds. When it is no longer able to use such funds for expansion of its operations, it will have to invest them, which could result in realization of interest or dividend income by the foreign corporation. If such income and other types of passive investment income constitute at least ten percent of the total gross income of the CFC, it becomes Subpart F income and is therefore taxable directly to the U.S. shareholders. I.R.C. § 954(b)(3)(A). The technique of investing the funds in tax-exempt municipal bonds in the U.S. can be used to avoid such adverse tax consequences since such investment is not treated as "investment in U.S. property," and the interest income derived from such bonds is not includable in the foreign corporation's gross income (and therefore in its Subpart F income). Rev. Rul. 72-427, 1972-2 C.B. 456; Rev. Rul. 71-14, 1971-2 C.B. 218; Rev. Rul. 72-454, 1972-2 C.B. 457.

IX. ACCUMULATION OF INVESTMENT INCOME THROUGH OFFSHORE CORPORATIONS

For all practical purposes, an offshore corporation can be used to accumulate investment income free from current U.S. taxes only if at least fifty percent of its stock is held by a nonresident alien. Thus, the U.S. investor must have at least an equal foreign partner. Otherwise, the pro rata share of investment income is taxable to the U.S. shareholder either as Subpart F income under section 951 or as foreign personal holding company income under section 551. In addition, it is possible that the foreign corporation could become a foreign investment company if it pursues an active investment policy (I.R.C. § 1246) which has the least favorable U.S. tax treatment. The consequences of this include denial of a stepped-up basis at the time of the shareholder's death.

Those U.S. taxpayers, as a result of a joint venture with a fifty percent foreign investor, are fortunate in that they hold only a fifty percent stock interest in the foreign corporation without current U.S. tax and can realize a long-term capital gain on the final liquidation of such foreign corporation or other disposition of their stock interests in the foreign corporation. Section 1248 does not apply to make such gain into ordinary income, since the foreign corporation is not a CFC.

X. U.S. VIRGIN ISLANDS

Seemingly, most of the problems indicated above could be avoided by using a U.S. corporation or a foreign corporation incorporated outside of the U.S. Virgin Islands (V.I.) which becomes an inhabitant of V.I. The idea of utilizing V.I. as a tax haven is based on the so-called "mirror theory."

The tax haven result follows from what seems to be an omission or error in establishing the mirror approach in V.I. The analysis is basically as follows: section 28(a) of the Revised Organic Act exempts inhabitants of V.I. from U.S. income tax. Thus, if a U.S. corporation becomes an inhabitant of V.I. (by establishing an office, residence, etc. in V.I.), it would no longer be subject to U.S. corporate taxes; it would be subject only to the taxes in V.I. It is true that V.I. has the same rules as the I.R.C. In V.I., however, the corporation (which is a U.S. or other non-V.I. corporation) is still a "foreign" corporation. As such, it would generally not be subject to V.I. taxes with respect to income derived by it from sources outside of V.I. (The only exception to this rule is if a fixed place or business in V.I. constitutes a material factor in the realization of foreign income. I.R.C. § 864(c)(4). This condition can normally be avoided without much difficulty). The net result is that a U.S. corporation or individual could establish a U.S. corporation (*e.g.*, in

Delware), or a non-V.I. foreign corporation which could then become an inhabitant of V.I. (by establishing its main office, seating directors, etc. there). It could then conduct business principally outside of V.I. In such a case, the bulk of its income would escape V.I. tax and any U.S. tax. If such a corporation is a U.S. corporation, its income could even be repatriated to the U.S. parent corporation completely free from any V.I. withholding tax and also exempt from U.S. corporate tax, since the one-hundred percent dividends-received deduction would apply to such intercorporate dividends.

Needless to say, there are several weak points to this analysis, including the questions of when and how the corporation can qualify as an inhabitant of V.I. If the analysis proves correct, however (which will have to be determined by the courts), U.S. taxpayers could avoid most of the tax restrictions of foreign operations and investments (including the Subpart F income provisions and foreign personal holding company income provisions of the I.R.C.) by employing the V.I. technique. For the time being, the problem in this area is caused by the complete lack of reliable authorities.

XI. DISCLOSURE REQUIREMENTS

Whenever a U.S. person acquires at least a five percent stock interest in a foreign corporation, he must report such fact to the IRS on Form 959 within ninety days. I.R.C. § 6046.

In addition, if the U.S. taxpayer owns more than fifty percent stock of the foreign corporation, he must attach Form 2952 (together with the financial statements of the foreign corporation) to his U.S. income tax return each year. I.R.C. § 6038. Thus, if the U.S. person does not own more than fifty percent of the stock of the foreign corporation, he may be required to give notice to the IRS only once, at the time he files the Form 959. In contrast, if he owns more than fifty percent of the stock of the foreign corporation, Form 2952 must be attached to his tax return each year while he retains such stock ownership, and the IRS can obtain fairly complete information on the foreign corporation from such forms and the enclosed financial statements of the foreign corporation.

Form 3646 is an annual information return which must be filed by each U.S. person who owns at least a ten percent stock interest in a CFC.

This form indicates to what extent the CFC's income might be taxable to the U.S. shareholder under the CFC rules.

Finally, Forms 957 and 958 must be filed on an annual basis with respect to a foreign corporation which is a foreign personal holding company.