# TAX CONSIDERATIONS FOR UNITED STATES OPERATIONS IN LATIN AMERICA†

*By Paul H. Johnson**

## I. INTRODUCTION

Tax complexities abound anytime a company goes overseas, whether it is making export sales, setting up a manufacturing operation, making a passive investment, or just sending an employee overseas for a brief period of time. All of these complexities will not be covered in this article, just some of the high points.

The starting point for income tax planning is the fact that the United States is one of only a few industrial nations that taxes its citizens and corporations on a global basis. Most other nations have a territorial concept of taxation; that is, only income from sources within that country is taxed. This conceptual difference is the key for tax planning in setting up an overseas operation for a United States taxpayer. The primary tax objective of a company going overseas is to minimize the combination of United States and foreign taxes imposed on the income earned overseas. Frequently it will be necessary to harmonize the tax laws of the United States, the host country, and perhaps also a third country.

## II. GENERAL BACKGROUND

While the United States does have this rather unique concept of taxing world-wide income of domestic corporations and citizens, the United States generally taxes foreign corporations and persons only to the extent that their income is effectively connected with a trade or business conducted in the United States. In addition, the government taxes certain types of passive United States source income. This general rule applies even if a foreign corporation is entirely owned as a subsidiary of a United States corporation. Therefore, one of the principal advantages of using a foreign corporation is the postponement of United States income tax until such time as the earnings of the foreign corporation are repatriated or distributed to the United States shareholder.

The amount of this deferral is the excess of the foreign corporation's net profit after taxes over the net profit after taxes which would have been realized if the operations had been carried out by a branch of the United

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* Partner, Peat, Marwick, Mitchell & Co., Houston; B.B.A., University of Mississippi; J.D., Harvard.

States corporation. This postponement of United States tax until earnings repatriation usually is significant only if the income of the foreign corporation is subject, in the foreign country or countries where it operates, to a lesser tax burden than the United States rate which is generally 48 percent. If the effective foreign income tax rate is approximately equal to or exceeds 48 percent, it often would be as desirable to carry out such foreign activities through a United States corporation. The United States grants double taxation relief through a foreign tax credit mechanism which reduces United States income taxes (with certain limitations) by the amount of foreign taxes paid on foreign source income which is also taxed by the United States. Moreover, if foreign losses are expected at the outset of overseas activities, a United States corporation may be preferable in order to obtain a current United States domestic tax benefit by deducting such losses. The Tax Reform Act of 1976, signed into law by President Ford on October 4, 1976, somewhat reduces the benefit of foreign losses by disallowing a portion of any otherwise allowable foreign tax credit in future years when foreign income is derived. In effect, foreign losses that reduced United States taxable income must be "recaptured" before a foreign tax credit may be claimed. Generally, however, no more than one-half of the foreign-source income for a year must be recaptured in that year.

If no foreign taxes are paid on the income, or if the effective foreign tax rate is less than 48 percent, the tax savings potentially can facilitate business growth and capital formation. The advantages of such deferral of United States income tax have, of course, not escaped the notice of Congress or the Internal Revenue Service. The United States tax laws, therefore, include a complex set of rules designed to preclude certain kinds of "tainted income" of a foreign subsidiary from being sheltered from current United States tax. Some of the more important of these rules, sometimes collectively referred to as the "Subpart F" rules, will be discussed later.

During the congressional debate on the Tax Reform Act of 1976, "deferral" became a dirty word. Since deferral has apparently replaced percentage depletion as the next target for tax reform in Congress we can predict much more activity in this area. If there is not a total elimination of the concept, greater restrictions likely will be imposed upon deferral.

## III. Setting Up the Overseas Operation

### A. *Choosing the Proper Form*

The first step in setting up an overseas operation is selection of the type of entity to be used. A branch of the United States corporation can be used with the parent company directly owning the assets, income, or losses. Alternatively, a United States subsidiary could be formed separate from the parent company to limit liability and the risk of expropriations. A United States subsidiary also may be important for insurance purposes or other non-tax reasons.

It may be desirable to set up a foreign subsidiary. Indeed, the host country might require that a local corporation be formed to conduct certain types of activities. Mexico, for example, generally limits foreign control of businesses and for a few sensitive industries[1] prohibits any foreign ownership.

A fourth possibility is to form a joint venture. The United States company and a company formed in the host country may decide to jointly conduct the operation. Once again, this might be a local requirement. Some countries require local ownership; some require a majority of local ownership. Nationalistic trends are in a constant state of flux and cannot be ignored by the tax planner. Frequently such non-tax considerations dictate the choice of entity.

### B. *Foreign and Domestic Tax Considerations*

Whatever vehicle the United States company chooses, it must determine the effect of its choice on its foreign tax liabilities. Foreign taxation is just as important as domestic tax consequences and frequently United States businessmen tend to lose sight of this. They concentrate on reducing or deferring the 48 percent United States tax and ignore everything else. For example, since most countries have higher tax rates than the United States, a business may cleverly avoid the 48 percent tax in the United States but wind up paying some other country a 70 percent tax.

Tax incentives abound overseas. Frequently these concessions are made to stimulate investment and employment in the host country and must be studied carefully in formulating the structure for doing business overseas. Ireland, for example, will exempt certain export-related operations from any Irish tax until 1990. Several countries provide rapid depreciation methods.

A foreign branch of either the United States manufacturing company or a separate United States subsidiary will be subjected to current United States taxation of its profits. It also will enjoy current deductibility of any losses. If start-up losses are expected, which is frequently the case, it can be quite advantageous to have the foreign operations initially in a domestic company.[2] If a United States subsidiary is used, its losses may be included in a consolidated tax return with its parent as long as stock possessing at least 80 percent of the voting power and at least 80 percent of the non-voting stock is owned by the parent. Another 1976 Tax Reform Act change,

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1. For example, the communication industry including television and radio.
2. This is subject to the 1976 Tax Reform Act change requiring recapture of foreign losses that reduced United States income before claiming foreign tax credits.

liberalizing Section 367 ruling requirements, enhances the flexibility of transferring assets overseas. Previously, the Internal Revenue Service had to give advance permission that a proposed transaction lacked United States tax avoidance motives before the transfer of assets could be consummated. This requirement frequently interfered with non-tax considerations and resulted in anomalous treatment. By 1978 this requirement, for most outbound transfers, will have been replaced by a post-transaction clearance procedure under which the United States transferor will have six months after the beginning of the transaction to request a determination from the Internal Revenue Service.

Planning for proper timing of income and credits is another important area of concern. Not all United States corporations pay taxes. For example, careful planning of dividend distributions from a foreign subsidiary must be made where the United States parent has net operating losses carried forward to prevent their expiration unused. Other more complicated permutations arise where the United States taxpayer has investment tax credit carryovers and foreign tax credit carryovers.

Another consideration, soon to disappear, is the Western Hemisphere Trade Corporation, which must be a United States corporation and must satisfy certain percentage requirements in order to qualify. Generally, such a corporation enjoys a 14 percentage point reduction in its tax rate. Rather than 48 percent it is 14 points less, or 34 percent. This reduction is being phased out gradually between now and 1980 so that after 1979 the full 48 percent rate will apply. However, it is not too late to obtain some tax benefits from Western Hemisphere operations outside the United States, which include all of North, Central, and South America and the West Indies.

### C. *The Subpart F Rules*

Attention must also be given to the Subpart F rules. Basically, these rules, if a business runs afoul of them, replace deferral with current United States taxation of foreign profits. This is not direct United States taxation of the foreign subsidiary but rather taxation of the United States shareholders of the foreign subsidiary. Prior to 1962 it was customary for American companies with foreign operations to reduce their overall tax burden through the use of tax haven subsidiaries.[3] For example, XYZ Corporation is a United States manufacturer of computers with export sales. Rather than directly making a sale to a customer in Brazil, XYZ would sell at a normal profit margin to its Bahamian subsidiary, which in turn would sell at the full market price to the customer in Brazil. The marketing profit on the computer would thus be captured in the Bahamian

3. Several nations have no tax whatsoever; the Bahamas, Bermuda, and the Cayman Islands are good examples. Switzerland has a low tax. The Netherlands imposes virtually no tax on business conducted outside Holland.

company, but the Bahamas does not have an income tax. The parent sold at a normal manufacturing profit so less than the full profit was taxable in the United States, and Brazil imposed no tax because no operations were conducted there. In this manner, the total profit XYZ earned on the computer sale attracted very little income tax.

During the Kennedy administration, drastic limitations were imposed on this technique through the enactment of Subpart F.[4] If United States shareholders own more than 50 percent of the total combined voting power of all classes of stock of a foreign corporation, it is defined as a controlled foreign corporation (CFC). For this purpose, only United States persons holding at least a 10 percent interest are counted. Although the Internal Revenue Code speaks of ownership of voting stock, the Internal Revenue Service regulations extend CFC status to foreign corporations if United States shareholders exercise voting control; thus, any arrangement to shift formal voting power away from United States shareholders will not be given effect if, in reality, voting power is retained.

Generally, if a CFC has Subpart F income, such tainted income, less related deductions, may be taxed to the United States shareholders as if it had been distributed to them. If the component of Subpart F income known as "foreign base company income" is less than 10 percent of the gross income of the CFC, none of this income is included in the income of the United States shareholders. If more than 70 percent of the gross income of a CFC is foreign base company income, then all of the CFC's income is so included. If foreign base company income constitutes between 10 percent and 70 percent of gross income, such income of the CFC, less related deductions, is included in the income of the United States shareholders.

Subpart F income includes income from the insurance of United States risks and foreign base company income. Foreign base company income comprises three principal elements: (1) foreign personal holding company income, (2) foreign base company services income, and (3) foreign base company sales income.

Foreign personal holding company income consists of investment income such as dividends, interests, and annuities. Also included are gains from the sale or exchange of stock or securities, certain futures transactions in commodities, and rents and royalities other than rents and royalties derived in the active conduct of a trade or business from unrelated persons.

Foreign base company services income is income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services for or on behalf of any related person where the services are performed outside the country of incorporation of the CFC.

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4. Now Sections 951 through 964 of the Internal Revenue Code.

Foreign base company sales income is the income of a CFC derived from the purchase and sale of property (1) when a related person is the seller or buyer, (2) the property is produced outside the country of incorporation of the CFC, and (3) the property is sold or purchased for use outside such country. Foreign base company sales income includes profits as well as fees and commissions on the purchase and sale of property if a related person is involved in either the purchase or sale. A "related person" for Subpart F purposes means a corporation affiliated through more than 50 percent voting stock ownership and any corporation under the same controlling ownership.

Even if a CFC successfully runs the gamut of the Subpart F rules, the United States shareholder will be subject to United States tax on the increase in the CFC's earnings that is invested in United States property. United States property includes tangible property located in the United States, stock or obligations of a domestic corporation that owns 10 percent or more of the CFC's stock or is at least 25 percent owned by the CFC's United States shareholders, obligations of certain other United States persons, including the guarantee of such obligations, and the right to use in the United States any patent, copyright, or similar property acquired or developed by the CFC for use in the United States. Assets acquired in normal commercial transactions, such as accounts receivable, are excluded.

To return to the example, XYZ has a controlled foreign corporation in the Bahamas and has sold a computer to it. There is a related party, XYZ, at one end of the transaction, and the computer was manufactured outside the Bahamas; thus, two of the three tests for foreign base company sales income are satisfied. If the Bahamian company sells the computer for use anywhere outside the Bahamas, the third test will be satisfied. Since the computer is being sold for use in Brazil, the Bahamian subsidiary's income would be tainted and, thus, included in XYZ's United States taxable income. Subpart F is not intended to tax foreign manufacturing operations, for example, a Brazilian subsidiary that has a plant in Brazil to manufacture products.

### D. *Tax Treaties*

Another significant area for study by the international tax planner is tax treaties. The United States has over 40 tax treaties in effect which are agreements between our government and the government of another nation. The tax treaties usually reduce the withholding tax which countries impose on income paid to recipients outside the source country. Treaties usually reduce somewhat the host country's jurisdiction to tax. For example, where the United States has a treaty with another country, a United States company typically may engage in slightly greater commercial activities in that country before subjecting itself to tax. The United States has no tax treaties with nations in Latin America other than certain of the Caribbean tax havens. Therefore, tax treaty considerations, at least in the context of Latin American investment, are virtually irrelevant.

Questions and Answers

*Question:* Please describe in detail the mechanics of the foreign tax credit. Also, in the example used, are any foreign taxes paid by XYZ's foreign subsidiary a tax deduction for the United States parent?

*Answer:* The United States taxpayer has an option to deduct foreign taxes paid directly or to claim a credit against its United States tax liability for foreign taxes paid both directly and indirectly. Typically, claiming the credit will be more advantageous since it is a dollar-for-dollar reduction in the United States tax liability. In essence, the United States yields to the foreign country the right to tax that item of income.

Foreign taxes paid by a CFC are not reflected in the parent's United States tax return until it either receives a dividend from the CFC or has Subpart F income. If the United States shareholder chooses to claim a credit rather than a deduction for foreign taxes, the dividend received must be "grossed-up" by the foreign taxes "deemed paid" and the total included in United States taxable income.

The amount of foreign taxes "deemed paid" by the United States shareholder is calculated by the following formula:

$$\text{Foreign income taxes paid by CFC} \times \frac{\text{Dividend paid}}{\text{After-tax earnings and profits of CFC}}$$

The "deemed paid" credit is illustrated in the following example: XYZ's Bahamian subsidiary has $100,000 of profits on which it pays foreign income taxes of $20,000. Out of the remaining accumulated profits of $80,000, it pays a $40,000 dividend to XYZ.

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|---|---|---|
| Total profits of CFC | $100,000 | |
| Foreign income taxes paid | (20,000) | |
| Accumulated after-tax profits | $ 80,000 | |
| Dividend paid to U.S. parent | $ 40,000 | |
| Foreign taxes deemed paid by U.S. parent: ($20,000 X 40,000/80,000) = | $ 10,000 | |
| | **If Credit Elected** | **If Not** |
| Dividend income to U.S. parent: | | |
| Actual distribution | $ 40,000 | $40,000 |
| Foreign taxes deemed paid | 10,000 | -0- |
| Taxable dividend income | $ 50,000 | $40,000 |
| U.S. tax (at 48 percent) | $ 24,000 | $19,200 |
| Less: foreign tax credit | (10,000) | -0- |
| U.S. tax payable | $ 14,000 | $19,200 |
| Combined tax burden (U.S. and foreign) | $ 24,000 | $29,200 |

The foreign tax credit is limited to the amount of United States tax imposed on foreign-source income that is included in its United States taxable income. The foreign tax creditable in any one year is limited according to the following formula:

$$\text{Maximum credit} = \text{U.S. income tax (on total taxable income)} \times \frac{\text{foreign-source taxable income}}{\text{total taxable income}}$$

For example, if the United States taxpayer has $100,000 of taxable income, one-third of which is foreign-source, on which the total United States tax is $30,000, its maximum foreign tax credit would be $10,000. Foreign taxes borne by it, including both direct and "deemed paid" taxes, are compared with this limitation. If less, the foreign tax is fully creditable; if greater, the excess may be carried back two years and forward five years to be claimed as a credit in those years, subject to the limitation of United States tax on foreign-source income of the carryback or carryover year.

*Question*: Will you elaborate on the use of Netherlands Antilles corporations for investments in the United States?

*Answer*: The United States has a tax treaty with the Netherlands which has been extended to the Netherlands Antilles, so the terms of treaties which the United States has with most industrialized nations in Europe also apply to the Netherlands Antilles which is a tax haven. The Antilles has an income tax but, generally, the rate is low and its scope is territorial with most income earned outside the Antilles escaping taxation; thus, there is only a small tax cost imposed by the Antilles. Netherlands Antilles corporations have become quite popular in Houston recently as a vehicle for real estate investments of foreigners who are from countries that do not have tax treaties with the United States, or for investors from high tax countries. A United States estate tax advantage also arises; for example, assume a foreign person, not a citizen of the United States, owns stock in a Netherlands Antilles corporation which owns this library building and rents it to the University of Houston. If that foreign person died owning the building directly, its value would be subject to United States estate tax. If he died owning stock in the Dutch Antilles corporation, it would not be subject to United States estate tax.

*Question*: This is more in the political realm. Will there by any cutting back of the favorable tax consequences for United States corporations doing business abroad, and if so, what areas would be changed?

*Answer*: Tightening or eliminating deferral is the one that is likely to come first. Labor unions argue that deferral causes runaway jobs by encouraging an American company to set up a plant outside the United States. This is no doubt true but it is not the whole picture. The other side of the coin is difficult to quantify but, nonetheless, valid. Use of cheaper foreign labor and the absence of costlier United States safety requirements permit United States companies to compete with foreign companies and obtain business they otherwise would lose. These incremental profits certainly create additional jobs and upgrade the type of work performed in the United States.

Another trend outside the United States is apparent. Foreign countries are enacting new tax laws or enforcing those already on the books more stringently. At the same time, Congress and the Internal Revenue Service have been tightening the United States foreign tax credit rules so more United States companies will be in excess foreign tax credit positions.

Another volatile area destined for more tinkering is the earned income exclusion of Section 911 of the Internal Revenue Code. A $15,000 exemption is now afforded individuals who earn income overseas. Until the Tax Reform Act of 1976, the exemption was $25,000 for foreign residents after their third year and $20,000 for others. Since United States employers frequently pay their expatriate employees' taxes in excess of a hypothetical tax, computed as if they had remained in the United States, this burden will fall on United States companies who, likely, will bring more employees back to the United States. Rather than create more jobs in the United States, this change is apt to create more jobs for foreign employees whose home countries do not tax their overseas earnings.

Surely, there has not been a final resolution of the controversial boycott sanctions. American companies that participate in international boycott activities, which are typically dictated by a country with which they do business against another country, have their foreign tax credit, deferral, and other benefits reduced proportionately.

*Question*: What would be the effect of granting United States tax incentives for United States companies to increase their business in Latin America?

*Answer*: Since the repeal of Western Hemisphere Trade Corporations will probably not significantly reduce United States business activity in Latin America, it is doubtful that granting other tax incentives would stimulate much additional business in Latin America.