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UNITED STATES TAXATION OF FOREIGN DIRECT INVESTMENT

Alan G. Choate*

I. The Tax Atmosphere of International Investment

The tax considerations are among the most important but least understood aspects of international investment.[1] "Foreign investors"[2] generally misunderstand the United States' concept of income taxation. It should be remembered that the United States raises almost all of its national revenue from income taxes, while most foreign countries raise a much smaller percentage of their national revenues from income taxes and a higher percentage from value added or other flat rate taxes.[3]

Furthermore, the United States exercises the broadest possible taxing jurisdiction under its Constitution. It taxes its citizens and residents on all of their income from all sources.[4] In many foreign countries, this is not

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1. With foreign direct investment in the United States increasing every year the ramifications of U.S. tax law on these investments also grows. In 1975 these investments reached $26.7 billion an increase of 46% over 1973 and this figure continues to grow. L. Lupo & G. Foech, "Foreign Direct Investment in the United States in 1975", 56-10 Survey of Current Business 34-36 (October 1976).

2. A "foreign investor" is defined by the United States Internal Revenue Code as "any corporation that is not a "domestic corporation". (I.R.C. § 7701(a)); and a "domestic corporation" is a corporation "created or organized in the U.S. or under the law of any state." [I.R.C. § 7701(a)(4)].

3. This is true of many foreign countries, especially European Countries who depend on value added and other indirect taxes for a large portion of their revenue. Belgium, for example, relies on income taxation for approximately 50% of total tax revenues, indirect taxes and duties produce the balance. See Tax & Trade Guide to Belgium, 3rd Edition, Arthur Anderson & Co.

4. I.R.C. § 3(a)(1), § 11(a) *et. seq*.

true. In those countries, income earned outside of the country may be subject to no tax, or at least not taxed until it is repatriated.[5] While these rules will be dealt with at somewhat greater length below, it is important for the foreign investor to understand that the relative importance of income tax considerations may be greater in the United States than in foreign countries.

This article, while broad in scope, is narrow in focus. It aims solely at those aspects of the United States' internal tax laws which should be considered by the foreign investor in planning for his investment. These tax considerations may affect the structure of operation of the business enterprise in the United States. The article is not intended as a short course in United States taxation, and the reader should be aware that the complexities of the United States Internal Revenue Code and the regulations issued thereunder are so great that no particular fact situation can be correctly analyzed except after detailed study by a tax professional.

A. Home Country Considerations

Initially, the foreign investor should carefully consider the tax situation in his country of origin. Just as the best tax situation is one where there is no taxation in either the home country or the foreign country, the worst situation is one where there is full taxation in both countries with no mechanism for relief from double taxation.

5. Venezuela, for example, follows the concept of territoriality which with some exceptions, exempts from taxation, income earned outside Venezuela, and disallows as deductions in the computations of taxable income, expenses incurred outside the country. See Tax & Trade Guide to Venezuela (3rd Edition) p.26, Arthur Anderson & Co.

Even if one country posits a reasonable rate of income tax, such as 50 percent, the ultimate disaster would be taxation of the same income in two countries with a resultant balance of zero. As indicated above, many foreign countries do not impose tax on operating income which has a foreign source.[6] The list of countries utilizing territoriality as a basis for income taxation is shrinking as the need for national revenue increases, but a substantial number of countries still fall in this category.[7] Most foreign countries impose no tax on income earned by foreign subsidiaries of their national corporations until such time as the dividends are remitted. A few jurisdictions do not even tax dividends from foreign sources in the same way they do not tax operating income from foreign sources.

Clearly, to the extent that income earned by a United States investment will not be subject to tax in the investor's home country, the investor is in a better position to plan his investment strategy in consideration of United States tax laws. Similarly, if the investment will definitely be subject to taxation in the United States, then the investor can focus on a strategy for the relief of economic double taxation, which is essential to preserve the foreign investor's return on his investment.

B. United States Tax Considerations

As mentioned above, the United States exercises an extremely broad jurisdiction to tax its residents and citizens. On the other hand, the United States exercises limited and relatively well-defined jurisdiction to tax non-resident,

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6. Venezuela for example, see note 5.
7. Id.

non-citizens.[8]

A "foreign investor" that sets up a place of business in the United States and does business with Americans will be subject to full United States taxation.[9] In the case of an individual, full taxation will result if the individual is treated as a resident.[10] In the case of a corporation, only the income which is "effectively connected"[11] with its United States' trade or business will be subject to United States taxation; and this income will be subject to the same taxation as would the income of a United States corporation.[12]

A foreign investor which does not set up a business operation in the United States, but which makes an investment in the stock of an existing corporation, will not be subject to tax on the business income directly. The corporation will pay tax and taxation will be imposed on dividends paid to the foreign investor.[13] Unlike United States investors, foreign investors are taxed at a flat rate on the gross amount of income they receive from dividends or other passive income from United States investments.[14] This is consistent with the American taxation policy of not exercising jurisdiction over foreign investors who are not doing business in the United States, since the tax must be collected by the United States payor of the dividends interest or other investment income. It is also possible for a foreign investor to do millions of dollars of business in the United States without becoming liable for any United

8. I.R.C. § 871 <u>et. seq</u>.
9. I.R.C. §§ 11-1201.
10. I.R.C. § 1, 2, 3.
11. I.R.C. § 864(a), Definition of "Effectively Connected" Income.
12. I.R.C. § 882.
13. I.R.C. § 881.
14. I.R.C. § 871.

States tax.[15]

C. Treaties for the Prevention of Double Taxation

The United States has a series of bilateral conventions with various foreign countries for the purpose of eliminating double taxation.[16] These treaties contain a number of valuable definitions, restrict the right of the participating countries to tax industrial and commercial profits between nations of the two countries, and also generally contain reduced rates of taxation for the types of income which are taxed by withholding at the source.[17] Certain types of income are also exempted from taxation,[18] and there are variations between the treaties so they must be individually checked if one is doing business with a national from a treaty country.[19]

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15. I.R.C. § 864(c)(1)(B). A foreign manufacturer for example may export his product to the United States and he will be totally free from United States tax so long as he does not do business through a United States office.

16. For example, the United States has such a treaty with Great Britain and Northern Ireland. The treaty applies to individuals, corporations and other persons including partnerships, estates and trusts, and avoids double taxation by allowing residents of each country to enjoy a tax credit against taxes paid to the other's government. [United States and United Kingdom Income Tax Treaty, (Dec. 31, 1971) Art. 8.]

17. The United States and the United Kingdom Income Tax Treaty for instance provides for reductions in the rate of United States tax on dividends paid by United States Corporations to United Kingdom shareholders. The rate is reduced from the standard rate of 30% to the treaty rate of 15%. [The United States and United Kingdom Income Tax Treaty (Dec. 31, 1971) Art. 7(2)(b)(i)(ii).

18. For example, there is no United States Tax on compensation received by a United Kingdom resident who renders individual personal services (e.g. lawyers, accountants, architects, etc.) in the United States if he is present in the United States for less than 184 days during the taxable year and he does not have a fixed base regularly available in the United States for business purposes. United States and United Kingdom Income Tax Treaty (Dec. 31, 1971).

19. The Income Tax Treaty between the United States and Finland, for example, does not exempt industrial royalties. United States and Finland Income Tax Treaty Feb. 28, 1971; while the treaty between the United States and Italy does exempt these royalties from taxation. The United States and Italy Income Tax Treaty, Feb. 1955.

II. Tax Considerations in Structuring a United States Acquisition

The attitude of many foreign investors is that the best way to make a business acquisition in the United States is to find the assets one wishes to purchase, pay for them, and begin doing business. From a business standpoint, this is certainly the proper approach. However, from a taxation standpoint, this approach, unless carefully considered, can be extremely expensive and can result in the taxation of income which might not otherwise be subject to tax. As a result, tax planning should begin before making a foreign investment.

A. Holding Companies

In many foreign countries, a "pure holding company"[20] is not subject to any taxes at all.[21] In the United States, holding companies have a different status. First of all, they are fully subject to taxation on all of their income, although they do benefit from the 85 percent dividend received deduction allowed corporate recipients of dividends from other United States corporations.[22] If they are "personal holding companies",[23] they are subject to a severe

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20. A holding company is usually defined as a company which has no business other than the passive holding of stocks and corporate securities and the purchase and sale of the securities. A broker/dealer would not be considered a holding company. In all countries, there will be limitations on the use of holding companies, but they are clearly a device for isolating income earned from a foreign investment from local taxation in many cases.

21. Canada, for example, does not tax pure holding companies.

22. I.R.C. § 245(A).

23. I.R.C. § 542; Definition of a "Personal Holding Company".

penalty tax,[24] and should, therefore be avoided.[25] However, a holding company which also has active business income, or the parent corporation of a group of companies which carry on active businesses, and which file a consolidated return, are not regarded as personal holding companies.[26] Further, if they own subsidiaries,[27] there is no taxation on dividends within the United States group.[28] One of the most attractive aspects of using a United States holding company for a series of United States investments is that losses from one investment can be offset against income from another.[29] Indeed, this is probably the major reason for the use of consolidated groups of companies. Dividends (except in limited circumstances) from a United States holding company paid to a foreign investor will be subject to withholding tax at 30 percent or a lower rate imposed by treaty.[30]

In some instances, a two-tiered holding company structure is recommended; utilizing a United States holding company for the reasons set forth above, and a "foreign holding company[31] incorporated in a jurisdiction which has a favorable tax treaty with the United States. A United States company may be desirable to procure United States investment in order to avoid taxation by withholding where otherwise tax deductions would be available to offset the income.[32] If a favorable treaty exists, and if there is no taxation of holding company income in the foreign country, this may

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24. I.R.C. § 541.

25. See Nicholson, Personal Holding Companies (Domestic) -- Taxation and Relief Tax Mgm't Port., No. 114-2nd (1974).

26. I.R.C. § 542(b)(1)(3)(4),(c).

27. To be considered in control of the subsidiary they must own at least 80% of the company.

28. I.R.C. § 542(b)(4).

29. I.R.C. § 542(3).

30. I.R.C. § 871.

31. I.R.C. § 552.

32. I.R.C. § 1442.

provide the best structure.[33]

B. Stock and Asset Acquisition

Both United States and foreign investors are familiar with the dilemma of whether to acquire stock or assets. There are advantages to both types of acquisitions, and most of them are unrelated to the tax side. However, careful consideration should be given to using the proper structure.

If a foreign investor wishes to acquire the assets of a United States business, he may do so through the use of a foreign corporation or a United States corporation, and may be able to do so in a tax-free manner in accordance with United States law. The principal difference between utilizing a United States subsidiary, and a direct acquisition by a foreign corporation, is that a United States subsidiary, in addition to being subject to income tax on all of its income,[34] will have to withhold tax on any dividends it pays.[35] This does not mean that the obvious choice is always to use a foreign corporation, since the United States acquisition will subject that corporation to full United States taxation on its United States business,[36] and, if it has a high enough percentage of United States source income,[37] it may also subject it to withholding by the United States.[38] Obviously,

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33. For example, if a foreign investor desires to buy a piece of equipment which will be utilized in the United States and rented to a United States company, direct ownership of the equipment would result in withholding on the rental income. By forming a United States company, the rental income could be offset with depreciation and interest deductions for any funds borrowed to acquire the asset and the resulting net income could be remitted in the form of a dividend from the United States company. If a treaty provides for reduced withholding, this will almost certainly be economically more advantageous than proceeding on a direct basis.
34. I.R.C. §§ 11; 1201.
35. I.R.C. § 862(3)(2).
36. I.R.C. §§ 11, 1201.
37. I.R.C. § 861.
38. I.R.C. § 862(a)(2).

tax-free acquisitions of American businesses by foreign corporations are more difficult to structure than taxable ones.

Even when stock of an existing United States corporation is to be acquired by the foreign investor, it may be wise to use a foreign corporation or a subsidiary incorporated in another country for purposes of making the acquisition. [Reasons for this are discussed above]. It is also more difficult to structure a tax-free acquisition by a foreign corporation than it is by a domestic one. In the case of individuals, the direct acquisition of United States corporate stock will subject the individual to United States estate tax.[39] This can be avoided if the acquisition is carried out by a foreign corporation.

As should be clear from the above discussion, the choice of structures can have a vast effect on the United States and foreign taxation of the income from a proposed foreign investment in the United States. If a foreign investor can carry on business here without a permanent business establishment in the United States, he may very well be able to avoid any United States taxation on his business income.[40] While legislation has been enacted in the United States which reduces the ability of a foreign investor to eliminate taxation on real estate investments,[41] some possibilities still remain. For one thing, an election is available under many of the double taxation treaties allowed a foreign individual or a corporation to be taxed on a net basis for real estate income.[42] Thus, a foreign investor can purchase United States

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39. I.R.C. § 20001 _et seq._
40. I.R.C. § 864(b)(2)(A)(i).
41. I.R.C. § 897.
42. United States - South Africa Income Tax Treaty.

real estate, lease it to United States users and benefit from interest and depreciation deductions,[43] which effectively wipes out any net income in the early years of the transaction. Under the treaty elections, there may also be no tax on subsequent sales if the net taxation election is not made in the year of sale and if the treaty exempts capital gains.[44] This is for a limited period of time, but still offers some opportunities to avoid United States tax.

The foreign investor is not completely free to use a treaty from whichever country it chooses. However, the formation of a holding company, in many jurisdictions can be utilized to take advantage of reduced rates of tax for certain types of income. While the United States Treasury Department has announced that its policy is against "treaty shopping", it is certainly still true that a great many foreign investments are currently being structured utilizing holding companies incorporated with a partial view to the benefits of a tax treaty. The same is true for withholding tax on dividends and other types of income. In addition, it may be possible to manage the income of a company so that a distribution will be treated as a reduction of capital rather than a dividend which would avoid withholding tax by definition.

III. Management of United States Income

A. The Leveraged Buy Out

A common method used for the acquisition of new

43. I.R.C. §§ 163, 167.
44. This is the case with South Africa which has no tax on capital gains and allows for the election of net basis taxation under the United States/South African Income Tax Treaty.

businesses is the leveraged buy-out.[45] The tax effect of a leveraged buy-out is that instead of two levels of taxation, one at the corporate level, and one when dividends are distributed; there is only taxation at the corporate level, before the funds are made available for repayment of principal on borrowed funds. Since foreign shareholders are generally not subject to United States tax on their dividends except by withholding, the double taxation problem may be less serious in the case of a foreign investor than it is in the case of the domestic one.[46] Care must be exercised, however, if funds to carry out the acquisition are borrowed from a foreign lender. After the merger takes place, if the company has United States source income, then the payments of interest by the company to the foreign lender will be subject to withholding and may generate additional payments under the lending documents.[47]

B. Dividends

A United States corporation does not receive a deduction for dividends paid. As pointed out above, dividends paid to foreign shareholders are subject to taxation by withholding at a 30 percent rate or a lower rate imposed by treaty.[48] Dividends received by American corporations receive the benefit of an 85 percent dividend received deduction, so that only 15 percent of the dividend is subject to tax.[49]

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45. In this type of transaction, the purchaser forms a company which purchases the stock (either all of the stock or a substantial percentage) of the target company and then merges with the target. The net result is, of course, that the debt incurred in the original purchase transaction becomes the debt of the acquired company.

46. I.R.C. § 871.

47. I.R.C. § 861.

48. I.R.C. § 871.

49. I.R.C. § 243(a)(1).

In fact, if more than 80 percent of the stock of another corporation is owned, it is treated as a subsidiary company and there is no tax on dividends paid from the subsidiary to the parent corporation.[50] Only United States corporations can benefit from this total dividend exclusion, and not even the 85 percent dividend received deduction is available for dividends paid by a foreign corporation to a United States corporate shareholder.[51] Not all distributions from a corporation are treated as dividends. If a corporation has no earnings, it may make distributions which will be treated as a return of capital. A return of capital would not be subject to tax even if paid to a foreign investor.

C. Interest

The Internal Revenue Code provides a deduction for interest paid.[52] When interest is paid to a "related party".[53] an arms length rate must be charged or the fiscal authorities are authorized to reallocate income to clearly reflect the income of both parties.[54] It is also true that in some cases a deduction for interest will be denied if the corporation is "thinly capitalized."[55] As with certain other categories of income, interest is subject to withholding tax when paid to foreign parties.[56] The statutory rate is 30 percent,[57]

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50. I.R.C. § 243(a)(2) & (3).
51. I.R.C. § 243(a)(1).
52. I.R.C. § 163(4).
53. I.R.C. § 267(b) Definition of "Related taxpayers".
54. I.R.C. § 267.
55. For example, a corporation with one thousand dollars in capital and one million dollars in debt might be denied a deduction for interest paid on the debt. The distribution would then be based as a dividend and could be subject to withholding as such. I.R.C. § 266.
56. I.R.C. § 871(a)(1)(A), § 1441, § 1442(A).
57. I.R.C. § 871(a)(1).

and this rate is reduced on a bilateral basis by double taxation conventions between the United States and various foreign countries.[58]

D. Royalties

Royalties are also deductible amounts so long as they are paid with respect to the use of industrial property or in the mining or extractive industry.[59] Under United States bilateral tax treaties, it is common to have reductions or exemptions for industrial property royalties in double taxation conventions between the United States and foreign countries.[60] It is less common to have an exemption for royalties from natural resources.[61]

E. Rent

Rents paid for the use of real or personal property are deductible by the lesses.[62] The lessor, as owner of rented property, is entitled to depreciate the property as well as to deduct interest associated debt incurred to acquire the

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58. The United States Income Tax Treaty with France for example, provides for only a 10% rate as long as the recipient is not "effectively connected" with the United States thru a permanent business establishment. United States/ France Income Tax Treaty (Aug. 11, 1968). See also Fed. Tax Coordinator, Vol. 20, Reg. 0-11053 for a list of all interest and withholding rates.

59. § 162 Tax Regs.

60. Under the United States/United Kingdom Income Tax Treaty for example, royalties and similar payments from United States sources to a United Kingdom resident for the use of parents, copyrights, copyright trademarks, designs, model plans, secret formulas or processes and industrial, commercial and scientific information are exempt from United States taxation, unless they are "effectively connected with a permanent establishment or fixed based in the United States/United Kingdom Income Tax Treaty, Dec. 31, 1971, Art. 12; Treasury Technical Explanation of United States/United Kingdom Treaty, Art. 12.

61. Income from "immovable property" (real property), including income from agriculture, forestry, mineral deposits, and natural resource is taxed by the United States if the property producing such income is located in the United States/ United Kingdom Income Tax Treaty, Dec. 31, 1971, Art. 6.

62. I.R.C. § 162(a)(2) & (3).

property.[63] Foreign investors who purchase real estate or personal property in the United States and wish to rent it, will generally prefer to be taxed on a net basis because of the availability of the offsetting deductions.[64] If the foreign investor does not elect to be taxed on a net basis or to be treated as doing business in the United States, the rents will be subject to withholding tax.[65] Under the treaties, there are few reductions in the withholding tax rate for rents.[66]

F. Depreciation

Depreciation[67] is the principal "non-cash" deduction offered by the United States fiscal authorities.[68] Depreciation is one of the devices used by Congress to encourage economic investment. It is available at an accelerated rate which does not relate to the economic useful life of the property involved.[69] In recent years, Congress has even made it possible for the tax benefits associated with leasing to

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63. I.R.C. § 167.

64. A non-resident alien or foreign corporation can elect to treat income from United States real property held for the production of income as effectively connected income. I.R.C. § 871(d), § 882(d). This allows the taxpayer to deduct taxes, interest and other expenses, as if the property was being used in a trade or business. Even if they are not engaged in business here, the Code provides an election to be taxed on a net basis. Many of the bilateral tax treaties also provide for such an election.

65. I.R.C. § 1441.

66. The United States Income Tax Treaty with Ireland for example provides for a withholding rates of only 15% if the recipient is subject to tax in his country of residence, and the income is not effectively connected through a permanent business establishment in the United States [The United States/Ireland Income Tax Treaty, Sept. 13, 1949.]

67. Depreciation is a deduction for the exhaustion, wear and tear (1) of property used in the trade or business or (2) of property held for the production of income. I.R.C. § 167(a).

68. Depletion of natural resources is another important "non-cash" deduction. I.R.C. § 611 *et seq*.

69. I.R.C. § 167(B)(4).

be "sold" to third parties in exchange for a cash consideration. The non-cash nature of depreciation deductions makes them particularly attractive in managing United States income to avoid the status of being considered a corporate distribution as a dividend subject to withholding. Cash may be made available for distribution to shareholders at a time when a company has no "earnings" because of depreciation deductions.

G. Management Charges

Realistic charges for management services are deductible. If they are to be paid to a related party, they must be at a reasonable arm's length rate.[70] Management charges can be used in planning for the production of United States source taxable income if that is desirable.[71]

IV. Tax Credits and Double Taxation

A. United States Credit for Foreign Taxes

The principal method for the elimination of economic double taxation in the United States is the statutory provision for the foreign tax credit.[72] A credit against tax is a direct, dollar for dollar offset of tax liability to the United States.[73] Thus where the same income is subject

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70. Foreign companies that provide management services to American companies should be careful to avoid the status of doing business in the United States. I.R.C. § 864(c). To avoid this all services must be performed outside of the United States.

71. In fact, in connection with the determination of United States or foreign source income, a United States company may be forced to take deductions for services performed by a foreign investor in the United States company. I.R.C. § 864 *et seq*.

72. I.R.C. §§ 901, 902, 906.

73. I.R.C. § 904.

to tax in two jurisdictions, the United States provides a credit for taxes paid to the other jurisdiction.[79] The credit can never exceed the tax payable to the United States, and is subject to a limitation based upon a fraction, the numerator of which is the foreign source income of the taxpayer and the denominator of which is the total taxable income.[75] The net effect of this limitation is to disallow a credit for taxes in excess of the effective marginal rate of taxation imposed in the United States on the same taxable income. It prevents a taxpayer from getting a windfall advantage from the tax credit provisions. The availability of foreign tax credits both in the United States and in certain foreign countries, are protected by specific provisions in some of the United States double taxation treaties.[76]

B. Foreign Credits for United States Taxes

Many foreign countries provide tax credits for United States taxes paid.[77] Thus, if a French company does business in the United States and is subject to United States tax on that income, it may benefit from a credit in a way similar to that discussed above.[78] Note, however, that double credits are never available.[79] Nonetheless, substantial

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74. The credit is limited to income taxes, and income taxes are defined to mean taxes based upon net income. Thus, value added taxes or gross receipts taxes will not generally qualify for the credit. A great many interpretations have been published by the Internal Revenue Service, and these should always be checked if there is a question as to whether a certain tax is creditable or not. I.R.C. §§ 901, 904, 896.

75. I.R.C. § 904(a) and (b).

76. United States/United Kingdom Income Tax Treaty, Dec. 31, 1975, Art. 23; United States/Denmark Income Tax Treaty, May 6, 1948, Art. XX.

77. See above, United States/United Kingdom Income Tax Treaty; United States/France Income Tax Treaty.

78. See, The United States/France Income Tax Treaty, August 11, 1968; also, Proc. 73-34, 1973-2 CB 489, as limited by I.R.C. § 904.

79. Obviously a corporation or individual will not be allowed to offset foreign and domestic taxes against each other and thus avoid paying tax altogether. See I.R.C. § 904 *et seq*.

planning opportunities, based on what types of credits are available in various countries, should be carried out in order to minimize the organization's overall tax liabilities.

The calculations of taxable income mentioned above may be somewhat different than those generally employed by the company. The United States, for example, allocates deductions under some fairly stringent rules.[80] Similarly, research and development expenses may be used to offset foreign source income if the research and development benefited foreign operations. General supervisory services may also be allocated against foreign source income.[81] This policy of the United States Internal Revenue Service represents a significant opportunity for reduction of United States taxes.

V. Tax Treaties as Tax Saving Devices

A. Direct Reduction of Tax Rates

As has been noted above, the United States and many foreign countries impose withholding tax on dividends, interest, rents, royalties and similar annual or periodic income.[82] One of the chief benefits provided by the double taxation treaties is a reduction or elimination of taxes on

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80. For example, interest payable on money borrowed in the United States may be allocated in part to offset income from foreign sources if the borrowed money was used to finance the foreign operation. See I.R.C. § 904(d).

81. This usually has the effect of reducing the foreign source taxable income and, therefore, the foreign tax credit available to American investors abroad. It has quite the opposite effect, however, for foreign investors in the United States since such expenses would serve to reduce the United States source income which might otherwise be subject to income taxation or United States withholding tax. This policy of the Internal Revenue Service represents a significant opportunity for reduction of United States taxes. See I.R.C. § 904.

82. I.R.C. § 871.

these amounts.[83] Withholding taxes typically vary between 25 and 35 percent, with the United States imposing the tax at a statutory rate of 30 percent.[84] These rates may be reduced, or certain types of income may be completely exempted by the tax treaties.[85]

B. Income Exempted from Tax

An important factor in taxation of international investment is the effect of the numerous bilateral tax conventions.[86] Certain types of income and certain types of taxpayers are exempted from taxation by the double taxation convention. There are often exemptions for students[87] and teachers,[86] capital gains,[89] certain types of royalties[90] and/or interest.[91] These exemptions have been negotiated between the United States and its treaty partners and serve to encourage investment between the two countries. It should be noted that capital gains of foreign investors are

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83. For example the United States/United Kingdom Income Tax Treaty eliminate the taxation between countries on interest earned in the other country and the [United States/ Italy Income Tax Treaty (Oct. 26, 1956)] exempts royalties from tax.

84. I.R.C. § 1442.

85. I.R.C. § 894(a)(b); United States/Canada Income Tax Treaty (March 4, 1942) reduces the withholding tax rate to 15%; United States/Romania Income Tax Treaty (Feb. 26, 1976) reduces the withholding tax rate to 10%.

86. Tax treaties between sovereign states began to effect international commerce at the end of the 19th century and presently the United States has 31 income tax treaties with foreign nations with several more under consideration. For a list of nations with which the United States has income tax treaties see International Aspects of United States Income Taxation, Elizabeth Owens, Part 4, Note p.47 (1980).

87. Income Tax Treaty between the United States and West Germany Art. XIII, (Jan. 1, 1953) exempts several types of income from tax, including royalties.

88. For example, West Germany Rev. Rul. 72-106, 1972-1CB277.

89. Income Tax Treaty between the United States and Belgium Art. 13 (Oct. 13, 1972).

90. Income Tax Treaty between the United States and Norway (Dec. 3, 1971), Art. 10.

91. Income Tax Treaty between the United States and Austria (Jan. 1, 1957) Art. VII.

generally exempt from United States tax.[92] However, capital gains generated by real estate holdings in the United States have recently been subjected to tax by the United States by an effective rate of 20 percent,[93] although treaty exemptions[94] for capital gains still override this legislation until 1985.[95]

VI. Currency and Exchange Problems

A. Taxation of Gain or Loss

The United States treats the United States dollar as only medium of exchange and, therefore, treats all foreign currencies as if they were commodities.[96] Foreign investors who do business in the United States in foreign currency, as is possible in many export/import transactions, may therefore, find that their taxable income in the United States includes gains or losses based upon the value of that foreign currency during the year.[97] All calculations of income and deduction in the United States must be made in United States dollars.

B. Hedging Transactions

Many companies in international business, especially

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92. I.R.C. § 881.
93. I.R.C. § 897 _et seq_.
94. I.R.C. § 894(a)(b).
95. See "Taxing Capital Gains of Foreign Investors: Its Only a Question of How", 9 Tax Notes 23-24 (1979).
96. In other words foreign currency is viewed as immediately transferable into United States dollars at the prevailing rates with the United States treating, francs for example, as a commodity of exchange comparable to say, cocoa or oil.
97. Thus profits or losses made thru the fluctuations in the exchange rate between currencies are calculated into a foreign corporation's taxable income. For instance if a French corporation lost money thru the devaluation of the Franc against the dollar that loss is deduced in figuring total corporate income. See generally I.R.C. § 1211 _et seq_.

those that have large inventories or carry out financing transactions, become involved in hedging currency risks. There are gains and losses depending on whether currencies are devalued or revalued, and these gains and losses form part of the income for any business in the United States.[97] If the hedging is associated with the day-to-day business of the company, the gains and losses will be treated as ordinary income or loss.[98] If they are entered into purely as financial transactions, they may generate capital gains, which are taxed at a lower rate.[99]

VII. Estate and Gift Tax

Just as residents of the United States are subject to tax on their income, they are also subject to tax on their estates upon their death,[100] and also upon gifts made during their lifetime.[101] Non-residents are not subject to tax upon all of their income, but only on that income connected with property located in the United States. In the case of federal estate tax, real property is taxed by the country in which the property is located.[102] In addition, tangible property has its situs where it is found.[103] Shares of a United States corporation are deemed to be situated in the United States regardless of the location of the certificates.[104]

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98. If the French Company used is an example in footnote 97 above was merely using currency to purchase assets, construct buildings, etc., then the financing loss or gain would be calculated as ordinary income under the standard tax rate for corporations. I.R.C. § 11 *et seq*.

99. If the French Company used in footnote 97 above was however investing in currency as a financial transaction in and of itself, then they would be able to apply the rate of capital gain. I.R.C. § 1202 *et seq*. or capital losses I.R.C. § 1211 *et seq*.

100. I.R.C. § 2001(a).

101. I.R.C. § 2501(a)(1).

102. I.R.C. §§ 2031(a), 2103, 2104.

103. I.R.C. § 2031(a).

104. I.R.C. § 2104(a).

This is also true of debt obligations of United States citizens.[105] For the gift tax, on the other hand, taxable transfers include only United States real property or tangible property whose situs is within the United States.[106]

VIII. The United States as a Tax Haven

A. Territoriality as a Method of Taxation

While the United States subjects its residents and citizens to full taxation on their worldwide income, that is not the case for most foreign countries. Many foreign countries impose taxes only on income sources within their own borders upon the rationale that other countries have jurisdiction over outside earning and thus will tax that income.[107] The existence of tax systems based on territoriality, and the existence of tax haven countries,[108] has given rise to a lively business in the utilization of foreign countries to minimize tax liability. Because the United States has such a well-developed fiscal authority, no one ever thinks of the United States as a tax haven.[109]

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105. I.R.C. § 2104(c).

106. I.R.C. § 2501(a)(2). Thus, an investor who resides in his home country but owns United States corporate stock will be subject to United States estate tax upon his death, but not subject to gift tax if he made a gift during his life time. For this reason, some foreign investors prefer foreign holding companies so that their own deaths do not trigger any United States estate tax.

107. Venzuela for example taxes under this system. See Tax and Trade Guide to Venezuela (3rd Edition) Arthur Anderson & Co.

108. For example Netherlands Entitles and the British Virgin Islands are attractive tax havens with investors and residents often able to avoid paying any tax at all.

109. For a post discussion of the United States as a tax haven see Ross, Report on United States Jurisdiction to Tax Foreign Income, XLIXL, Studies on Int'l Fiscal Law 184 (1964).

As the reader will have noted from the discussion above however, there are various categories of income which are not subject to tax.

Almost all foreign source income of foreign corporations which are not "doing business" in the United States is free of United States tax.[110] If, pursuant to a territorial doctrine, the income from sales in the United States is not subject to tax in the home country, then the entire income from these transactions will not be subject to taxation. Even if taxation cannot be avoided entirely, it may be possible, either directly or through a company formed in a jurisdiction which imposes no taxes, to carry out a two-tiered sales operation where there is a sale to the foreign tax haven company at a relatively low price followed by a sale by that company in the United States with no subsequent taxation by the United States.

IX. Conclusion

It was not the goal of this article to make the reader an expert on United States income taxation. Indeed, the intricacy of the Internal Revenue Code, the regulations promulgated under that Code, the multiple other source of published opinions from the Internal Revenue Service and the United States courts are so vast that they require many years of specialized training to master. What we have tried to do in this article, however, is to give the reader some idea of the ways in which foreign investments in the United States

110. I.R.C. § 864(c). This is true even if the foreign corporation is selling millions of dollars worth of products in the United States as long as the company itself is not selling the products in the United States and the terms of the sale are such that the income has a foreign source.

are taxed by the United States, and also some of the methods which are utilized to reduce the overall burden of taxation through the structuring of investments and commercial transactions. This is so much a part of business life in the United States that most American businessman do not even think of themselves as engaging in tax planning. It would be grevious error, however, for a foreign investor to ignore the necessity for tax planning with respect to his United States investments.