**SAUL LARNER, Ph.D.**
**MODULE 1**
**ASSIGNMENT**

## 1. NON TAX ISSUES FOR INVESTING OVERSEAS

A. Business viability
B. Availability of resources
C. Market access
D. Market potential
E. Political and economic stability
F. Government grants and incentives
G. Geographic location
H. Business infrastructure
I. Availability of a skilled and low cost work force
J. Strong currency—less risk of devaluation
K. Asset protection—prevent buyers from coming back to demand refunds.
L. Better copyright and patent laws and enforcement (There are a lot of finite differences in various countries).
M. Some people like to be able to spend more time in certain countries.
N. Some people feel a social responsibility to help certain countries grow.
O. Some people wish for an excuse to visit a country more.
P. I have heard of people who open branches to keep friends and relatives employed.
Q. Belief in the work culture and economic value system of the country (such as China).
R. Management is more productive than burdensome.
S. International financing takes place more efficiently and readily offshore.
T. Employees will have a better quality of life on their salaries.
U. International financing has more flexibility as well. Financing instruments offer more readily an array of variations in types of interest, maturity dates, advance refunding and conversion possibilities.
V. Potentials for more structured insurance and re-insurance. Many high-risk insurance policies (such as political risk or environmental casualty) could not be written onshore because of government regulation and taxation, and many insurance companies would be forced to significantly increase premiums if they were not allowed to reinsure groups of risk.
W. It is a haven for those who understand the risks associated with investment and finance and therefore do not need government interference with their decision processes.
X. Lack of traceability of intangible goods.

**Y. Abolished withholding taxes on dividends as well as other taxes.**
**Z. Avoid domestic liability for economic hazards.**
**AA. Government assistance programs. (Grants, help with labor supply and other labor issues.**
**BB. Higher return and acceptable risk are usually better.**

**2. WHAT IS AN INTERMEDIARY ENTITY?**

**This is an entity where there is a broker or agent to negotiate between two parties, as opposed to an owner doing the negotiations. This is by one definition. However, perhaps in this course, the answer has to do with conduit financing as it pertains to Section 7701(1). If nothing else, this section gives us the boundaries within which regulations must be framed. The IRS, will of course, be expected to look beyond its bare terms for its tax-favored patterns of international investment.**

**Common patterns of financing through intermediary entities—back-to-back loans, guarantees, pledges and other security arrangements-are built on contractual links sufficiently concerted to make them "transactions".**

**A. Reasons you might wish to use an intermediary entity**

1. **Help in treaty shopping or take advantage of special tax incentives and exemptions and tax concessions.**
2. **Allow finance to be raised from international capital markets at lower cost.**
3. **Assist in transfer of funds through an acceptable profit extraction or diversion within a global organization. They hold the profits overseas for reinvestment or defer their distribution to the home country until it can be done in a tax-beneficial manner.**
4. **Greater knowledge and skills**
5. **Ease of stricter confidentiality**
6. **More economical structuring of legal mechanisms including all types of documents and formations.**
7. **Knowledge of many variables, such as currency risks and fluctuations which will be used to negotiate more effectively.**
8. **Political, social and business connections which should reduce costs for formation, structuring and operating the business.**
9. **Knowledge of import and export issues and variables.**
10. **Knowledge of laws as they relate to asset protection.**
11. **Knowledge to accomplish the goals as set forth in the answers to the first question above.**

**In order to conclude this answer, I must close by saying that in summary, both debt and equity are two key elements of a "financing transaction". The stock in a corporation can be in the form of a similar interest in a partnership or trust that has some essential features of debt. It can also include in the same category of being a "financing transaction" if it is a lease, a license or any other transaction in which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent of cash.**

3. **WHAT ARE THE DIFFERENCES BETWEEN DEBT AND EQUITY IN FOREIGN INVESTMENT?**

    A. **Introductory statement:**
        1. **For those who really want to get into this and possibly as a paper, a good source is "William T. Plumb, The Federal Income Tax Significance of Corporate Debt, 26 Tax L. Rev. 369 (1971).**
        2. **Once the nature of a foreign entity is set, the classification of the interests held in it by its owners still poses problems. The tax regime imposed on CFC's for example, turns significantly on the degree of voting control held by U.S. shareholders as does the indirect credit for foreign income taxes under section 902. It is therefore often necessary to identify voting stock and voting power in foreign entities against a background of foreign corporate norms differing appreciable from those of U.S. law.**

    B. **Dividends (equity) and interest (debt) are treated differently in foreign taxation.**
    C. **Many countries impose withholding taxes on dividends (equity) but not on interest (debt), particularly if there is a tax treaty with the U.S.**
    D. **Debt interests in foreign corporations do not contribute toward their status as CFC's. The corporate debt is usually a capital asset in the hands of a U.S. person and transactions involving that debt (its retirement or transfer, for example, will normally entail a large amount of return of capital (thus permitting the repatriation of foreign earnings at a low tax cost).**
    E. **Many of the exciting maneuvers that once could be carried out with debt in foreign corporations have been blunted by recent changes in U.S. taxation.**
    F. **As stated above, DEBT constitutes BONDS. EQUITY constitutes shares in the company. Here are some characteristics of debt (bonds).**

        1. **Loans to company with or without interest payments as opposed to equity which is a return payable in dividends.**
        2. **Interest in debt (bonds) are payable at regular intervals or maturity.**

**3. Interest in debt is either fixed or variable where dividends are based on profits (equity).**
**4. With debt (bonds), the loan can be unsecured or guaranteed by the parent company.**
**5. With debt, there can be a back to back arrangement**
**6. Loan can be paid back in local or an agreed to foreign currency.**
**7. Borrower is obligated to comply with loan covenants, but in equity there is no commitment expect to pay dividends.**
**8. Per all of the above, of course, with both equity and debt, the holder of the securities can sell their holdings at a profit or loss.**

**G. There can be hybrid instruments which combine both.**
**1. Convertible loans**
**2. Option loans**
**3. Subordinated loans**
**4. Profit participation instruments**

**H. Deduction of dividends (equity) is often changing in favor of the stockholder.**

**I. Interest expense (debt) is disallowed over "excess limitation".**

**J. As a dividend is distributed from TAXED profits and the interest is paid from pre-tax profits, the borrower can reduce these taxes by financing primarily through debt (as opposed to equity).**

**K. Loans may be obtained in any currency to avoid foreign risk.**

**L. "Double Dipping". This is a double deduction that can be obtained for the interest costs if the parent company borrows at home to invest in a foreign subsidiary in a tax haven, which then grants a loan to a sister subsidiary in the host country. (This is one example as to how intermediary is used).**

**M. Unlike dividends, interest income does not suffer from economic double taxation in the hands of the borrower or lender.**

**N. Equity may be preferred if there is low withholding tax on dividends in the host country and the foreign dividends are tax exempt at home. Also, if there are restrictions on the use of loan capital. The interest may not be deductible until paid and not on an accrual basis.**

**O. Under normal circumstances, debt is preferred to equity. The borrower can reduce his taxes by financing primarily through debt as opposed to equity capital.**

**4. DIFFERENT TYPES OF ENTITIES YOU WOULD CONSIDER AS AN OVERSEAS INVESTOR.**

**1. AGENCY. In order to deter a taxable event, the agent must be economically and legally independent, and preferably not act for only a single principal.**

**He must bear the entrepreneurial risks and be free to ac t without detailed instructions from the principal. (He is known in this country as an independent contractor). One example would be to hire this person to generate sales in a foreign country or pay him to produce "widgets". The disadvantage is that he cannot produce either just for you and you might not like to see him work for others as you may need his entire production and keep your ideas secret.**

## 2. LICENSING ARRANGEMENT

**Licensing a foreign entity to manufacture or market goods or services can be a low cost alternative to setting up one's own business presence abroad. The advantage is that it requires no cash investment and earns licensing royalties on the transfers of technology and other intangible rights. In addition, it provides the opportunities for the sale of specialized plant and equipment, raw materials or semi-finished components, training, technical assistance, etc. More advantages are that the licenser benefits from the existing market penetration, the marketing and distribution systems, local knowledge and connections and the operational facilities of the licensee.**

**The disadvantages are that once the overseas business activity is established, he may have problems in retaining effective control over the business conducted by the licensee. It may also limit his ability to establish his own presence in that market in future or to maintain or increase the royalty rates after a specified period. There is also the potential risk of inadequate protection over the intangible property rights. Nevertheless, licensing is widely used and is an attractive low-cost way to expand the business abroad.**

## 3. FRANCHISING

**This is a contractual relationship between the franchiser and franchisee. The franchiser grants a limited license to the franchisee for his system. He offers and maintains a continuing interest in the business of the franchisee in areas, such as marketing, quality control, systems, know-how and training. The franchisee makes a substantial capital investment in the business form his own resources and operates under the common trade name, marketing and systems provided by the franchiser.**

**Unlike a pure licensing arrangement as above, it is probable that the franchiser will be deemed to have a permanent establishment in the host country. He will also be exposed to transfer pricing issues and the product and service risks incurred by the franchisee.**

## 4. REPRESENTATIVE OFFICE

**A business presence can be maintained through a low-cost representative office. The disadvantage is that as a branch, it becomes taxable in the source state because it is a permanent establishment. However, depending on the jurisdiction, it can maintain a supply of goods, handle advertising, supply information and other activities on a tax-free basis. That is the advantage.**

**5.BRANCH**

**It is the same legal entity as the head office and its other branches. The company retains full ownership and control over its branch. It operates under the name of the company and the financial results are included in the company's accounts. The advantages are that there are no minimum capital requirements and no capital taxes, stamp duties or withholding taxes on remittances. It can be set up easily. There is no double taxation on the profits repatriated to the head office. The controlled foreign corporation rules do not apply.**
**It is unsuitable for long-term overseas investment or operations. It subjects the parent company to unlimited liability on its obligations. The local regulations may require a public filing of the parent's audited accounts and subject it to public disclosure.**

**A good strategy is to set up a branch during the period of start-up losses and to convert it to a subsidiary later when it becomes profitable.**

**6. COMPANY**

**One advantage is that it is usually more tax-beneficial as an entity than a branch. Like a branch, it is normally not taxable as a nonresident permanent establishment. It permits the deferral of tax by the State of the parent company until its profits are declared as dividends There are other tax planning opportunities which include the justified use of profit extraction techniques and structures involving intermediary offshore entities.**

**The disadvantages are that it has more demanding set-up and compliance requirements. It is subject to anti-avoidance measures, such as thin capitalization rules, transfer pricing and controlled foreign corporation rules. The dividend payments are subject to economic double taxation in countries using the classical tax system. There is usually no relief for the losses of the subsidiary. In some countries, a local company also requires equity participation by local residences.**

**7. PARTNERSHIP**

**Partnerships may be taxed as "pass through entities" where the individual partners bear the tax, or as companies subject to corporate tax.**

**The liability is limited and they cannot benefit usually from tax treaties. It can be a suitable entity for tax purposes because as pass through entities, they avoid the economic double taxation on dividends under the classical tax system.**

**A big disadvantage is that one of the partners usually has to assume unlimited liability.**

9. **FOREIGN TRUSTS WITH U.S. GRANTORS**
10. **TRUE TRUSTS**
11. **FOREIGN TRUSTS WITH FOREIGN GRANTORS**
12. **HYBRID STRUCTURES**
13. **LIMITED LIABILITY COMPANIES**
14. **COMPANIES LIMITED BY SHARES**
15. **COMPANIES LIMITED BY GUARANTEES**
16. **COMPANIES LIMITED BY BOTH SHARES AND GUARANTEES**
17. **NO LIABILITY COMPANIES**
18. **UNLIMITED COMPANIES**
19. **MUTUAL COMPANIES**
20. **REGISTERED LISTED COMPANIES**
21. **CAPITAL MAINTRENANCE EXEMPT COMPANIES**
22. **INERNATIONAL BUSINESS COMPANIES**

**I am not elaborating herewith on these last ones because whereas they weren't in the assigned reading, I assumed that it was getting into depth. As I do the paper in this module, I will refer to them. Otherwise, in future chapters. If I am inappropriate in not elaborating herein, please afford me the opportunity to further complete this answer. Thank you.**

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