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Selected Tax Aspects of Foreign Investment in Domestic Joint Ventures

by

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INTRODUCTION

The increasing amount and degree of foreign investment into the United States has brought with it an almost equally increasing sensitivity to the effect of the new U.S. tax reforms on maximization of return in domestic joint ventures. Indeed, the tax burden on joint venture investments is often a primary concern for foreign investors, corporate or otherwise, who structure investment into the United States. In particular, this article will focus on taxation that affects formation, the combined tax burden of operations and repatriation of profits, as well as gift and estate taxes on transfer of the investment. A significant portion of a foreign investor's overall tax burden is, of course, its home country tax liability. Yet, while this aspect of the overall analysis must be addressed by the planner in each specific instance, its consideration, as well as that of U.S. state and local taxation, is beyond the scope of this article.

Income tax treaties between the United States and foreign countries affect the regime of taxation of a joint venture in a variety of contexts. The most significant effect is the reduction of the withholding tax rate on repatriation of profits. Accordingly, our treaty infrastructure gives rise to a major classification in the type of foreign investors: treaty and nontreaty investors.

This article looks at nine typical investment models and evaluates potential tax exposure in the contexts of formation, operations, repatriation, and gift and estate transfers for both nontreaty and treaty investors. Given the
significant differences among the treaties to which the United States is a signatory, the authors have limited their consideration of treaty investors to those from one treaty partner, Japan.

I. GENERAL TAX CONSIDERATIONS

As noted above, foreign investors may be classified as nontreaty or treaty investors. The Internal Revenue Code [hereinafter Code] applies to nontreaty investors and, as varied by the rules of an applicable treaty, to the treaty investor as well. For this reason, it is appropriate to introduce standing by themselves the tax considerations underlying and affecting a foreign investor's choices in a transactional context. Thus, before proceeding to an analysis of the investment models, the authors will analyze the way in which the relevant Code provisions affect these considerations for the nontreaty investor, as well as the way these considerations are varied by the United States — Japan income tax treaty.

A. Formation

A foreign investor may enter business in the United States in at least four ways: (1) start up a new enterprise; (2) acquire the stock or assets of an existing business; (3) enter into a joint venture with a U.S. investor or U.S. business; or (4) license technology to a U.S. business. This article will focus on a combination of the second and the third options, acquisition by a foreign investor of the assets or stock of an existing business in a joint venture context, on the assumption that the foreign investor is contributing capital, rather than technology, to a joint venture with a U.S. investor.

1. Limitations on Types of Businesses

The United States has limited foreign ownership in certain industries by imposing restrictions that either prohibit foreign ownership within a specific industry or allow foreign ownership while restricting foreign participation in certain corporate activities. Examples of prohibition on ownership include radio and television licenses, which cannot be issued to aliens, foreign corporations, or domestic corporations with significant alien ownership. Examples of the limitation on activities are defense industries which limit access to classified materials in the case of any business which is under foreign ownership.

1. For tax purposes, foreign investors are nonresident aliens, defined at section 7701 of the Internal Revenue Code of 1986, as amended, to include foreign individuals, trusts, partnerships, and estates.
control, or influence and national banks which do not preclude foreign ownership but require that the directors be U.S. citizens and that the president of a national bank be a director.

2. Corporations

Whether a foreign investor’s contribution to a corporate joint venture takes the form of assets or capital, section 351 provides for nonrecognition of gain on the transfer of property to a joint venture if immediately after the transfer, the transferor holds eighty percent of the combined voting power of all classes of stock entitled to vote and eighty percent of all other classes of stock. It should be carefully noted that the eighty percent requirement is met when the investing group, taken as a whole, acquires eighty percent control. Thus, in the case of virtually every joint venture that takes the corporate form, neither gain nor loss will be recognized on the contribution of assets or capital by the joint venturer. The basis of stock received in a section 351 transaction is the same as the basis of the property contributed. Thus, if a venturer contributes property with a basis of 20x and a fair market value of 100x, the venturer’s basis in the stock received in a section 351 transaction will be 20x.

3. Partnerships

Section 721(a) provides for nonrecognition on the transfer of property to a partnership in exchange for an interest in the partnership. Thus, contribution by an investor to a joint venture which takes the partnership form will not result in gain recognition. As in the case of a corporation, the investor’s

4. See id. § 76.
6. An example of this general principle is set out in section 367, which may apply to joint venture formations with the result that certain nonrecognition provisions, such as section 351, are lost. A nonrecognition provision is one which allows a taxpayer to defer recognition of gain in certain transactions, such as contribution of property to a corporation in exchange for eighty percent or more of its stock. However, where section 367 applies to a given transaction, a ruling must be obtained in order to receive the benefit of deferring gain recognition. For example, section 367(b) applies to transfers of foreign property to a U.S. person and transfers among foreign corporations with common U.S. ownership. Specific transactions affected include: (1) liquidation of a foreign subsidiary into its foreign parent, section 332; (2) transfer of foreign stock by one foreign corporation to another foreign corporation that the transferor controls immediately after the exchange, section 351; and (3) a corporate reorganization in which a U.S. shareholder exchanges stock of a foreign corporation, section 354. A transfer of property by a partnership (whether foreign or domestic) to a foreign corporation in an exchange described in section 367(a)(1) is considered an indirect outbound transfer. I.R.C. § 367(a)(4) 1986. A similar outcome results if a U.S. person transfers a general, as opposed to a limited, partnership interest.
7. Id. § 358(a)(1).
8. Section 1491 is an exception to section 721 which imposes a thirty-five percent excise tax on the appreciation inherent in any property contributed by a U.S. person as capital to a foreign entity. The tax does not apply to a transaction, such as a section 361 transaction, described in section 357. Under section 1492, the tax is not imposed if gain is recognized under
basis in the property contributed will be the same as his or its basis in the partnership interest received.\(^9\) If the property contributed has a basis of 20\(x\) and a fair market value of 100\(x\), the investor's capital account in the partnership may be assigned a value of 100\(x\), but only if there is a special allocation of gains to the partner of the difference between book value and fair market value.\(^10\) The partner's initial basis in this partnership interest is the adjusted basis of the property contributed.\(^11\)

If the fair market value of the contributed property exceeds its adjusted basis, the partners can agree on allocations of profits and losses pursuant to the book-up provisions of section 704(b)(2). If a book-up allocation is undesirable, instead of one partner contributing low-basis property to an equal partnership, each could agree to contribute an equal amount of cash and then purchase the property. The disadvantage of this method is that the partner contributing the low-basis property will not be able to defer the taxable gain. Note that a partner's deductible share of partnership loss is limited to the adjusted basis of his partnership interest.\(^12\)

\[\phantom{\text{section 6.328}}\]

4. \textit{Alternative Forms of Contributing Money or Property}

Capitalization of a corporate joint venture should include some degree of debt to reduce taxation on the return of the investment, by virtue of the fact that: (i) interest is deductible at the corporate level, whereas dividends are not; and (ii) tax treaties generally are more generous in reducing the U.S. withholding tax rate on interest than on dividends. In this connection, the thin capitalization provisions of the home country and of section 385 and regulations promulgated thereunder governing domestic corporations should be consulted to assure that the Internal Revenue Service [hereinafter IRS] respects the division of debt and equity.

Another planning alternative is for the foreign member to provide services to the corporation or to license an asset such as patent technology to the venture.\(^13\) Some planning opportunities also exist through intercompany pricing to avoid U.S. source income,\(^14\) subject, however, to the Commissioner's ability to recast pricing to reflect arm's length value, pursuant to section 482.

\(^9\) I.R.C. § 723 (1986).
\(^10\) \textit{Id.} § 704(b)(2); Treas. Reg. § 1.704-1(b)(2)(iv)(g) (as amended in 1986).
\(^11\) I.R.C. section 722 and Treasury Regulation section 1.705-1(a)(2) make the partner's capital account irrelevant for the purpose of determining a partner's basis in the partnership. Upon disposition, gain is generally allocated to the contributing partner in accordance with his capital account, which increases his basis.
\(^12\) I.R.C. § 704(d) (1986).
\(^13\) For example, if the foreign investment takes the form of a contribution of technology, return on that investment can, in turn, take the form of a deductible royalty. \textit{Id.} § 162(a)(3).
\(^14\) \textit{Id.} § 861.
5. Corporation and Partnership Domicile

The domicile of a corporation is its place of incorporation or organization regardless of the residence of its shareholders. A foreign corporation is any corporation organized in any place other than the United States. Possessions corporations, as that term is described in section 936, are also considered foreign corporations.

Partnerships are deemed domiciled where the organization is formed regardless of whether their partners are U.S. persons or nonresidents. Note, however, that this is a somewhat facile definition, since it may be difficult to determine where a partnership between residents of two jurisdictions is formed, absent a formal partnership document.

B. Operations

1. Definition of "engaged in U.S. trade or business"

The Code does not define what is meant by the phrase "engaged in U.S. trade or business," as used in section 864(b), but the cases generally rely on factors such as the place where decisions are made and operating control is located. Thus, whether a nonresident alien is considered, for tax purposes, to be engaged in a U.S. trade or business is a question of fact to be decided in each case, dependent on the nature and extent of his economic contacts with the United States.

Whether periodical income of the type specified in section 871(a)(1) is effectively connected with the conduct of a trade or business in the United States depends on whether income, gain, or loss derives from assets used in or held for use in the conduct of a trade or business (the "assets-use" test) or whether business activities in the United States were a material factor in the generation of income, gain, or loss (the "material factor" test).

An asset is treated as used in, or held for use in, the conduct of a trade or business in the United States if it is held to promote the present conduct of the trade or business, is held in the ordinary course of the trade or business, or is otherwise held in a direct relationship to the business. Such a relationship exists if the asset is presently needed in the taxpayer's business, for instance, meeting a business' operating expenses, but does not exist if the asset is merely held in anticipation of growth. There is a presumption of direct relationship where the asset is acquired with funds from the trade or business, the income from the asset is reinvested, and U.S. personnel actively involved

15. Id. § 7701(a)(5).
20. Id. § 864(c)(2)(B).
in the trade or business exercise significant management and control over investment of the asset.\textsuperscript{21}

The business activities test applies where an activity is a material factor in production of income, except that investment portfolio management activities will not be treated as activities conducted in the United States. Note that non-U.S. source income may also be effectively connected with the conduct of a trade or business in the United States and, therefore, taxable to a nonresident alien.\textsuperscript{22}

2. Corporations

U.S. business carried on through either foreign or domestic corporations is subject to two levels of tax: income taxes on business income at the corporate level,\textsuperscript{23} and a second-level tax on distributions to shareholders.\textsuperscript{24} In the case of domestic corporations, the dividend distribution is included in the shareholder’s taxable income and is subject to graduated tax as provided in sections 1 or 11, as the case may be. And in the case of foreign shareholders, the distribution of dividends is subject to withholding tax, under section 1441 or 1442, at a rate of thirty percent of gross, unless that rate is reduced by an applicable treaty.

A foreign corporation engaged in a U.S. trade or business through a branch is subject to income tax on its business income effectively connected with its U.S. business at the same graduated rates of taxation as a domestic corporation.\textsuperscript{25} It is also subject to a branch profits tax of thirty percent on remittances to the foreign parent of such.\textsuperscript{26} It can only avoid dividend withholding if the foreign corporation conducts business in the United States, in which case the foreign corporation is subject to the branch profits tax.\textsuperscript{27} The applicable treaty may reduce the dividend withholding rate, and it may reduce the rate of or eliminate the branch profits tax.\textsuperscript{28}

3. Partnerships

Nonresident aliens or foreign corporations that are partners of foreign or domestic partnerships engaged in a U.S. trade or business are themselves deemed to be engaged in that trade or business.\textsuperscript{29} Accordingly, a nonresident alien partner is subject to tax on his or its distributive share of the partnership

\textsuperscript{22} I.R.C. §§ 864(c)(4)(B)-(C), 897(a)(1) (1986).
\textsuperscript{23} Id. § 11.
\textsuperscript{24} Id. §§ 1, 11, 1441, 1442.
\textsuperscript{25} Id. § 882(a)(1).
\textsuperscript{26} Id. § 884.
\textsuperscript{27} Id. §§ 884, 1442(b).
\textsuperscript{28} See infra note 36 and accompanying text.
\textsuperscript{29} I.R.C. § 875(1) (1986). Nonresident individuals file a return on form 1040-NR.
income, not just on amounts actually distributed. By contrast, a nonresident shareholder of a domestic corporation is not subject to direct U.S. tax.

C. Distributions to Foreign Persons

1. Distributions of Corporate Income

Under section 1441, payments of fixed or determinable, annual or periodical [hereinafter FDAP] income made by domestic corporations to nonresident alien individuals, foreign partnerships, or foreign corporations are subject to withholding at the rate of thirty percent of gross, unless this requirement is modified by treaty. Section 1441 imposes the withholding obligation on anyone with custody or control of the payment, which, in the usual case, is the payor. The withholding tax is the actual tax on the income.

a. Distributions of Partnership Income

The Tax Reform Act of 1986 enacted section 1446, which added a twenty percent withholding tax on distributions from foreign or domestic partnerships to foreign partners if the partnership has income, gain, or loss that is effectively connected or treated as effectively connected with the conduct of a trade or business within the United States. This withholding requirement is effective for tax years beginning after December 31, 1987, unless the initial regulations provide for an earlier date. The amount withheld is treated as a credit against actual tax liability and is subject to a refund by filing a U.S. tax return. The amount of the withholding is reduced proportionately if less than eighty percent of the partnership's total income is effectively connected with a U.S. trade or business for three consecutive years.

b. Branch Profits Tax

If a foreign corporation engages in business in the United States through an unincorporated entity, section 884 imposes a tax on the branch's earnings and profits attributable to its income effectively connected with its U.S.
The branch profits tax on foreign corporations is effective for taxable years beginning after December 31, 1986, and applies even if the foreign corporation has made an election pursuant to section 897(i) to be treated like a domestic corporation. Since the branch profits tax is imposed on income effectively connected with a U.S. trade or business, the tax also applies to foreign corporations that are partners in a partnership which derives income effectively connected with a U.S. trade or business. The branch profits tax is levied in addition to corporate income tax imposed at section 11 rates by section 882 and the alternative minimum tax imposed by section 1201(a).

Although the branch profits tax is intended to achieve parity between the remittance of branch profits and distributions of subsidiary earnings, many exceptions exist. For example, to the extent that a branch’s income is reinvested in the United States, the income subject to this tax is reduced. The greatest benefit of this exception obtains if no remittances are made until the foreign corporation terminates all of its U.S. operations and liquidates the branch, in which case the branch profits tax does not apply and the entire investment profit, less any tax at the corporate level upon liquidation, is remitted outside the United States without additional tax.

Also, the tax base of the branch profits tax rests upon an earnings and profits concept rather than on a taxable income concept with the result that a branch can have no taxable income and still be subject to branch profits tax.

D. Reductions of Taxable Income

1. Deductions

a. Expenses

Nonresident aliens or foreign corporations engaged in a U.S. trade or business are entitled to certain “qualifying expenses” as deductions against income under sections 873 (nonresident alien individuals) and 882(c) (foreign corporations).

Section 861 and the regulations promulgated thereunder require the taxpayer to allocate deductions among classes of income, i.e., royalties, rents, or income from operations, and, if necessary, to apportion the deductions within the corresponding class of gross income. For foreign corporations engaged


38. Id. § 884(b)(1).

39. See I.R.S. Notice 86-17, 1986-52 I.R.B. 19. Note, however, that this notice precedes regulations under section 884 and subsequent regulations could change this result. Highly-placed members of the Internal Revenue Service have informed the authors that if the regulations under section 884 varied the results under I.R.S. Notice 86-17, they would only do so prospectively.

40. The term “qualifying expenses” refers to expenses which are related to a class of gross income.

41. Treas. Reg. § 1.861-8(a)(2) (as amended in 1984). Therefore, qualifying expenses are allocable to that class if they are incurred as a result of or incident to an activity, or in connection with property, from which that class of gross income is derived. Id. § 1.861-8(b)(2).
in business in the United States, the statutory grouping\(^{42}\) is that corporation's income which is effectively connected with the conduct of a trade or business within the United States; residual income is typically any foreign source income. For partnerships engaged in business, the allocation and apportionment of deductions occurs at the partnership level, not at the partner level.\(^{43}\) There is an exception for interest expense which is allocated and apportioned at the partner level for foreign corporate partners.\(^{44}\) In addition, the amount of the state corporate income and franchise tax may also be deductible under section 882(c)(1).\(^{45}\)

b. **Dividends Received Deduction**

Section 243 allows foreign and domestic corporations a deduction against income for dividends received from a domestic corporation. The deduction is limited to eighty percent of the dividend received.\(^{46}\) To qualify, the payor and its affiliated corporations must be members of an affiliated group,\(^{47}\) which excludes all foreign corporations except those organized in Mexico and Canada.\(^{48}\) Also, the recipient of dividends is entitled to the deduction only to the extent that a foreign corporation is involved in a U.S. trade or business and the dividend received is effectively connected with that particular business. However, if a foreign corporation's only U.S. source income is FDAP income, then the deduction would be lost since the foreign recipient is not engaged in trade or business in the United States.

c. **Dividends Paid Deduction**

A corporation can use dividends paid out to offset its tax liability on accumulated earnings. Section 531 imposes an accumulated earnings tax on corporations described in section 532 where the IRS determines that the accumulation is unreasonable and in purposeful avoidance of income tax by its shareholders.\(^{49}\) Section 532 includes all corporations except personal holding

\(^{42}\) The term "statutory grouping" refers to the gross income from a specific source or activity, which must first be determined in order to arrive at taxable income from such specific source or activity under an operative provision of the I.R.C. *Id.* § 1.861(a)(4).

\(^{43}\) I.R.C. § 702(b) (1986); Rev. Rul. 85-60, 1985-1 C.B. 187.


\(^{46}\) A 100 percent deduction is available where the dividend is a qualifying dividend pursuant to I.R.C. section 243(b). Note, however, that the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, *reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS* 12B-1 [hereinafter OBRA], reduces the dividends received deduction from eighty percent to seventy percent where the recipient owns less than twenty percent, by vote and value, of the paying corporation's stock. This change is effective for dividends received or accrued after December 31, 1987. In most cases involving joint ventures of this nature, the twenty percent limitation should not be a problem and, accordingly, an eighty percent exclusion will be assumed in the calculation contained in this article.

\(^{47}\) Affiliated group is defined in I.R.C. section 1504(a).


\(^{49}\) *Id.* § 533; Treas. Reg. § 1.533-1 (as amended in 1963).
companies, foreign personal holding companies, and tax-exempt corporations. If subject to the accumulated earnings tax, a foreign corporation can reduce its accumulated income subject to that tax by the amount of the dividends paid deduction so long as the distribution is includable in the gross income of a foreign corporation or individual.

2. Exclusions

Section 883 provides for certain exclusions from gross income of foreign corporations whose business operations are related to the transportation industry. For example, a foreign corporation which makes use of ships or aircraft in its business effectively connected to the United States is entitled to this exclusion, if such crafts are documented under the laws of a foreign country and that country grants an equivalent exemption to U.S. citizens and U.S. corporations.

3. Consolidated Returns

Section 1501 permits corporations in an affiliated group to file a consolidated return. If a foreign corporation conducts operations through a U.S. subsidiary, that subsidiary can file a consolidated return with other domestic corporations affiliated with it in the same chain of ownership. For the foreign investor with multiple investments in the United States, profits of one enterprise can be offset by the losses of others, so long as they qualify as a U.S. affiliated group. If the foreign corporation conducts business through a foreign subsidiary, a foreign branch or a foreign or domestic partnership, the losses generated by these enterprises may not be used against other business investments in the United States.

4. Modification by Treaty

Favorable tax treaties will modify, reduce, or preclude the application of the branch profits tax if the foreign corporation is a qualified resident of such foreign country, that is, generally, if fifty percent or more of its owners by financial value are bona fide residents of the treaty jurisdiction or if the stock is publicly traded in the treaty jurisdiction. In Notice 87-56, the IRS listed the countries with which the United States has tax treaties in effect on August 18, 1987, which override the branch profits tax. The ruling also identifies

50. Personal holding corporations are defined in I.R.C. section 542.
51. Foreign personal holding companies are defined in I.R.C. section 552.
52. Tax exempt corporations are defined in I.R.C. section 501.
56. Id. § 1501.
57. Id. § 884(e).
58. These are: Aruba, Austria, Belgium, People's Republic of China, Cyprus, Denmark, Egypt, Finland, Germany, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea,
those countries with which the United States has a treaty, which, subject to
certain limitations contained in some of the treaties, permits the imposition of
branch profits tax, but at the rate applicable to dividends paid to a corporate
resident of one contracting state by a wholly-owned subsidiary resident in the
other contracting state, unless the rate of tax on branch profits tax is specified
in the treaty.59 If the treaty does not allow a branch profits tax but does
allow the second-level withholding tax on dividends, second-level withholding
will apply.60

Section 884(f)(1)(A) provides for similar rules so that interest paid by a
foreign corporation's U.S. trade or business is not subject to tax under sec-
tions 871 or 881 or to withholding under sections 1441 or 1442. Thus, inter-
est is not taxable where the recipient of interest paid by a foreign
corporation's U.S. trade or business is a qualified resident61 of a foreign coun-
try which exempts or reduces the rate of tax that applies to interest paid by a
foreign corporation or where the payor corporation is a qualified resident of a
treaty country which exempts or reduces the rate of tax.

E. Gift Tax

1. Corporate Stock

Stock in a U.S. corporation and debt obligations of a U.S. person are
U.S. situs property subject to U.S. gift tax. However, the gratuitous transfer
of stock in a U.S. corporation or debt obligations of U.S. persons held by
nonresident alien persons is generally not subject to U.S. gift tax because such
property is intangible and the transfer by nonresidents of intangible property
is excepted from U.S. gift tax.62 This exception does not apply if the nonresi-
dent donor was a U.S. citizen within ten years of the gift.63 The transfer of
stock of a foreign corporation does not subject nonresident aliens to U.S. gift

Luxembourg, Malta, Morocco, Netherlands, the Netherlands Antilles, Norway, Pakistan, Philip-
tion, that treaties with Aruba and the Netherlands Antilles have been revoked, effective January
1, 1988, except with respect to certain interest payments. See Treasury News Releases B-1033
(June 29, 1987), B-1038 (July 2, 1987), B-1046 (July 10, 1987), reprinted in 3 Tax Treaties (CCH)
¶¶ 9815-17 (1987).

59. These countries are: Australia, Barbados, Canada, France, New Zealand, Poland,
60. The proposed amendment of section 884(e)(3) of the Corrections Act reads:
If a foreign corporation is not subject to the tax imposed by subsection (a), for any
taxable year determined after the application of any treaty, no tax shall be imposed
by section 871(a), 881(a), 1441, or 1442 on any dividends paid by such corporation
out of earnings and profits for such taxable year.
The proposed new text of section 884(e) also eliminates the current exception in I.R.C. section
884(e)(1)(B). Corrections Act, supra note 36, § 112(o). These changes have been reintroduced as
section 16(q) of the 1988 Technical Corrections Act, supra note 36.
61. Qualified resident is defined in I.R.C. section 884(e)(4).
63. I.R.C. §§ 2501(a)(3), 2511(b) (1986); Treas. Reg. § 25.2511-3(a)(2) (as amended in
1973).
tax, unless the foreign corporation is treated as a conduit or is disregarded as a sham.\textsuperscript{64}

2. Partnership Interests

Whether section 2501(b) can be reasonably interpreted to mean that there is no gift tax on the transfer of interests in a partnership by a nonresident individual is an open question, determined by the same principles applicable to intangible transfer of interests in foreign corporations. The issue is whether the partner has an intangible interest in the entity or a tangible interest in the entity's underlying assets. If the latter view prevails and if the underlying property is located in the United States, the transfer is subject to U.S. gift tax.\textsuperscript{65}

\section*{F. Estate Tax}

The taxable estate of a nonresident alien individual includes all tangible or intangible property situated in the United States in which the alien had an interest or is deemed to have had an interest at death.\textsuperscript{66}

1. Corporate Stock

Section 2103 and section 2104 include stock of a U.S. corporation in the estate of a nonresident decedent.\textsuperscript{67} Stock of a foreign corporation is not included in the estate of a nonresident alien decedent,\textsuperscript{68} assuming that the foreign corporation is not a conduit or a sham.

2. Partnership Interests

U.S. situs intangible property is subject to U.S. estate tax. However, "[a]lthough potentially a major understatement, it appears fair to say that the partnership interest situs rules for a U.S. estate tax purpose are not entirely clear."\textsuperscript{69} Perhaps the safest alternative is to conclude that a partnership interest will be “considered a U.S. situs property, if the partnership is itself engaged in a U.S. trade or business.”\textsuperscript{70}

\begin{itemize}
\item \textsuperscript{64} I.R.C. § 2501(a)(2), (a)(3)(B) (1986). \textit{See also} Tillman v. United States, 355 F.2d 632 (Cl. Ct. 1966).
\item \textsuperscript{66} I.R.C. §§ 2101, 2103, 2031(a) (1986).
\item \textsuperscript{67} \textit{Id.} §§ 2103, 2104; Treas. Reg. § 20.2104-1(a)(5) (as amended in 1974); cf. Treas. Reg. § 301.7701-5 (as amended in 1967)(which defines domestic and foreign corporations).
\item \textsuperscript{68} I.R.C. § 2104(a) (1986); Treas. Reg. § 20.2105-1(f) (as amended in 1974).
\item \textsuperscript{69} Hirsh, \textit{supra} note 65, at 416.
\item \textsuperscript{70} \textit{Id.} Due to this rule, a partnership offers a significant advantage either where a U.S. real property interest is undeveloped U.S. real estate held for appreciation or where no income from rent is planned. For a discussion of the several theories that have emerged, \textit{see id.}, \textit{supra} note 65, at 416-33.
\end{itemize}
3. Treaties

The United States has a number of gift, as well as combined estate and gift tax treaties in force, which can vary the Code rules governing U.S. situs property for estate tax purposes.\(^71\)

G. General Tax Treaty Considerations

The United States has negotiated tax treaties with most but not all of its trading partners.\(^72\) Under the general rule, treaty obligations prevail over the Code.\(^73\) However, section 112(y) of the Technical Corrections Act of 1987 [hereinafter Corrections Act]? would amend section 7852(d) and the traditional rule, such that, where specifically intended by Congress, certain Code provisions enacted by the Tax Reform Act of 1986 would override treaty obligations.

H. Income Tax Treaty Between Japan and the United States

1. Relief from Double Taxation

The Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [hereinafter Tax Treaty]\(^75\) permits a foreign tax credit for taxes paid to the other country, apart from the provisions of section 902. The Tax Treaty foreign tax credit is also available in situations where a corporation of one country receives a dividend from a corporation of the other country in which it has at least a ten percent ownership interest.\(^76\)

2. Sources of Income

Business profits from the corporation of one country attributable to a permanent establishment in the other will be considered as being from

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\(^71\) The list of signatory countries to such treaties includes: Australia (also a separate gift tax treaty), Austria (combined estate and gift tax treaty), Canada (this treaty will cease to have effect with respect to estates of persons deceased on or after January 1, 1985), Denmark (combined estate and gift tax treaty), Finland, France (combined estate and gift tax treaty), Germany (combined estate and gift tax treaty), Greece, Ireland, Italy, Japan (combined estate and gift tax treaty), Netherlands, Norway, Sweden (combined estate and gift tax treaty), Switzerland, Union of South Africa, and the United Kingdom (combined estate and gift tax treaty).

\(^72\) The United States has income tax treaties in force with the following countries: Aruba, Australia, Austria, Barbados, Belgium, Canada, People's Republic of China, Cyprus, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, Netherlands, Netherlands Antilles, New Zealand, Norway, Pakistan, Philippines, Poland, Romania, Sweden, Switzerland, Trinidad & Tobago, Union of Soviet Socialist Republics, and the United Kingdom. 1987-35 I.R.B. 9.

\(^73\) I.R.C. § 7852(d) (1986).


\(^76\) Id., art. 5 at 976, T.I.A.S. No. 7365 at 10.
sources within the country in which the permanent establishment is located.\textsuperscript{77} These profits will only be taxable in that country to the extent that they are attributable to the permanent establishment.\textsuperscript{78}

3. Withholding

a. Dividends

The rate of withholding in the source country on dividends derived by a resident of the other country is limited to fifteen percent if the recipient does not have a permanent establishment in the country to which the dividends are effectively connected.\textsuperscript{79} Withholding is reduced to ten percent in the case of intercorporate dividends, where the recipient corporation owns at least ten percent of the payor corporation and the payor derives not more than twenty-five percent of the income from interest and dividends. An exception to this latter requirement is made if interest and dividends are received from the operation of a banking business or a subsidiary corporation more than fifty percent of whose voting shares is owned by the payor.\textsuperscript{80}

The reduced withholding tax does not apply if the recipient corporation has a permanent establishment in the payor's country and the shares with respect to which the dividends are paid are effectively connected with that permanent establishment.\textsuperscript{81} For example, if a Japanese corporation had a permanent establishment in the United States (such as a branch) and it received a dividend from a U.S. corporation, the shares of which are effectively connected with the permanent establishment, no treaty relief from the thirty percent withholding rate would apply.

b. Interest and Royalties

The rate of withholding tax in the source country on interest and royalties derived by a resident of the other country is limited to ten percent, unless the recipient has a permanent establishment in the source country and the interest and royalties are effectively connected with the permanent establishment.\textsuperscript{82}

c. Nondiscrimination

Article 7 of the Tax Treaty contains a nondiscrimination clause which essentially prohibits the imposition by one country of any tax on citizens or entities owned by the citizens of the other country that is more burdensome

\textsuperscript{77} Id., art. 8 at 982-84, T.I.A.S. No. 7365 at 16-18.
\textsuperscript{78} Id.
\textsuperscript{79} Id., art. 12(2)(a) at 988-89, T.I.A.S. No. 7365 at 22-23.
\textsuperscript{80} Id., art. 12(2)(b).
\textsuperscript{81} Id., art. 12(3) at 989, T.I.A.S. No. 7365 at 23.
\textsuperscript{82} Id., arts. 13, 14 at 990-93, T.I.A.S. No. 7365 at 24-27.
than the taxes borne by the citizens and entities of the first country. For example, if a U.S. branch owned by a Japanese parent bore a greater burden of tax than a U.S. branch of a U.S. corporation, the nondiscrimination clause would have been violated.

II. CONSIDERATION OF VARIOUS INVESTMENT MODELS

A. Model I

The first model is a simple corporate joint venture formed by a foreign investor and a U.S. citizen, each of whom became shareholders of a U.S. corporation which operates a U.S. business. In the case of these models, it does not matter whether or not the foreign investor is a corporation, except as may be indicated.

1. Nontreaty Investor

a. Capitalization

In a joint venture situation, although neither the foreign investor nor the U.S. investor may hold as much as eighty percent of the U.S. corporation, the nonrecognition principles of section 351 are available, so long as both venturers contribute property to the corporation as part of the same transaction.

b. Effects on the Foreign Investor

The combined U.S. tax burden for the foreign investor is 53.8 percent: thirty-four percent is imposed on the corporate profits and a thirty percent

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83. See also I.R.S. Notice 86-17, 1986-52 I.R.B. 19 (stating that in the case of a qualified resident of Japan, the Tax Treaty overrides the branch profits tax).

84. The authors acknowledge William K. Norman, Esq.'s graphic renditions of the models in an outline of a similar topic at the California State Bar Taxation Section's Annual Foreign Tax Institute in Los Angeles on June 9, 1987.


withholding tax is imposed on the repatriation of the remaining sixty-six percent, whether as dividend or interest.\textsuperscript{87} Branch profits tax does not apply.\textsuperscript{88}

The fact that the foreign investor holds a share of a domestic corporation will not cause that investor to be deemed engaged in a U.S. trade or business.\textsuperscript{89} If the foreign investor is an individual who participates in the business and receives a salary or other form of remuneration in connection with the business, assuming that the investor's presence in the United States does not subject him to taxation as a resident,\textsuperscript{90} the investor is subject to taxation on his income effectively connected with the conduct of a trade or business in the United States.\textsuperscript{91} In this case, the investor is also subject to the thirty percent withholding rate on FDAP income.

c. \textit{Effects on the U.S. Investor}

The combined U.S. tax burden for the U.S. investor is 52.48 percent: thirty-four percent is imposed on corporate profit\textsuperscript{92} and after 1987, a maximum of twenty-eight percent is imposed on distribution of the remaining sixty-six percent, whether as dividends or interest.\textsuperscript{93}

The use of tax benefits occurs at the corporate level, consequently, little relief is afforded under this model. If the U.S. investor is a corporation, it is entitled to the section 243 dividends received deduction, thus lowering the tax burden to 38.49 percent \((.34 + (.66 \times .2 \times .34))\), assuming that the U.S. investor owns less than eighty percent of the corporate joint venture.

d. \textit{Estate and Gift Tax Effects}

Disposition by the foreign investor of its share in the U.S. corporation is not subject to U.S. gift tax\textsuperscript{94} but is subject to U.S. estate tax.\textsuperscript{95}

2. \textit{Treaty Investor}

Subject to limitations on interest and dividend income,\textsuperscript{96} article 12 reduces to ten percent the withholding rate on dividends paid by the U.S. corporation to the foreigner, if the Japanese investor owns more than ten percent of the venture and is not otherwise engaged in business in the United

\textsuperscript{87} Id. § 1441.
\textsuperscript{88} Id. § 884.
\textsuperscript{89} Id. § 864(b)(2)(A).
\textsuperscript{90} Id. § 7701(b).
\textsuperscript{91} Id. §§ 871(b).
\textsuperscript{92} Id. § 11.
\textsuperscript{93} Id. § 1.
\textsuperscript{94} Id. § 2501(a)(2).
\textsuperscript{95} Id. §§ 2103, 2031.
\textsuperscript{96} See Part I.H.3.a.
States. This reduction, in effect, lowers the Japanese investor's U.S. tax burden to 40.6 percent \((0.34 + (0.66 \times 0.10))\), exclusive of Japanese tax. The burden is the same whether the payments were characterized as interest or royalties.

\[ \text{B. Model II} \]

In the second model, the foreign investor holds the shares of the U.S. corporate joint venture through a foreign corporation, while the U.S. investor holds its share of the venture through a U.S. corporation. The interposition gives a particular advantage to the foreign investor with regards to U.S. estate tax.

1. *Nontreaty Investor*
   
a. *Capitalization*

   Contribution of assets by the foreign investor to the foreign corporation is controlled by the law of the investor's home country. The foreign corporation may contribute appreciated property to the U.S. venture corporation free of tax, under section 351, on the assumption that the venture corporation is funded by both the foreign and the U.S. corporation as part of the same transaction.

b. *Effects on the Foreign Investor*

   The combined U.S. tax burden for the foreign investor is 53.8 percent. In addition, the investor may be subject to two additional levels of tax under local foreign law: taxation on the foreign corporation's income and taxation at the individual level.
The foreign investor cannot elect to file a consolidated return under section 1504(b)(3). Since the foreign corporation will not be deemed engaged in business in the United States, it cannot use the dividends received deduction for the remittance from the U.S. corporation to the foreign corporation. To the extent the U.S. corporation is subject to the accumulated earnings tax under section 531, it can use the dividends paid deduction of section 561.

c. Effects on the U.S. Investor

The combined U.S. tax burden for the U.S. investor using 1988 rates is 55.71 percent. Corporate earnings of the venture corporation are subject to a thirty-four percent tax. The remaining sixty-six percent, after the eighty percent dividends received deduction, bears a 4.49 percent tax burden on distribution to the U.S. corporation. The remaining 61.51 percent bears a twenty-eight percent tax in the hands of the individual U.S. shareholder. It is assumed that the U.S. corporation owns less than eighty percent of the venture corporation, thus making the amount of the dividends received deduction eighty percent, rather than 100 percent.

d. Estate and Gift Tax Effects

Since the estate of the foreign individual will hold its investment through stock of a foreign corporation, the investor will be subject to neither U.S. estate nor gift tax.

2. Treaty Investor

Assuming in this joint venture situation that the foreign corporation holds more than ten percent of the U.S. corporation and that, given an active business, not more than twenty-five percent of the U.S. corporation's income is from interest and dividends, article 12 of the Tax Treaty will reduce to ten percent the rate of withholding on the dividend from the venture corporation to the Japanese corporation. This rate is the same whether the distribution takes the form of interest or royalties. The total U.S. tax burden on the Japanese investor will, therefore, be 40.6 percent (thirty-four percent + 6.6 percent), although the investor may still be subject to additional Japanese corporate and individual taxation.

97. Id.
C. Model III

In this model, the foreign investor elaborates the structure of Model II by holding his share of the U.S. venture corporation through a U.S. holding corporation, thus, simultaneously subjecting the investment to an additional layer of U.S. tax, while at the same time availing himself of both the dividends received deduction and the consolidated return provisions, as well as favorable estate tax treatment.

1. Nontreaty Investor

a. Capitalization

To the extent that the foreign corporation contributes appreciated assets to the venture, the contribution will be tax free under section 351. Contribution to the U.S. holding corporation will clearly be tax free. Contribution by the U.S. holding corporation to the U.S. venture corporation will also be tax free under section 351 to the extent that it is part of the same transaction as funding by the U.S. investor.
b. Effects on the Foreign Investor

The foreign investor's combined U.S. tax burden is 56.94 percent: thirty-four percent maximum rate at the corporate level operating the business,98 4.49 percent on the U.S. holding corporation as a result of the dividends received deduction (.66 x .2 x .34),99 thirty percent withholding on distributions of the remaining 61.51 percent from the U.S. holding corporation to the foreign corporation (18.45 percent).100 To the extent that there are losses and that the U.S. holding corporation and its subsidiary constitute an affiliated group, losses generated by the venture could be used to offset other income of the U.S. holding corporation. In addition, the foreign investor may be subject to taxation on the foreign corporation's income and taxation at the individual level under its local laws.

The foreign corporation cannot be a member of the affiliated group for purposes of filing a consolidated return because of section 1504(b)(3), but, as noted above, the combined U.S. tax burden is reduced by the availability of the eighty percent dividends received deduction on distributions from the U.S. venture investor corporation to the U.S. holding corporation. The foreign corporation cannot use the dividends received deduction since the corporation is not subject to tax under section 882.

To the extent that the foreign investor's U.S. corporations are subject to the accumulated earnings tax of section 513, the dividends paid deduction is available.

c. Effects on the U.S. Investor

The taxation of the U.S. investor is identical to that under Model II.

d. Estate and Gift Tax Effects

Since the nonresident investor holds the U.S. investment through the share of a foreign corporation, he will be subject to neither U.S. estate nor gift tax.

2. Treaty Investor

As was the case with the previous model, article 12 can reduce the withholding tax on the distribution from the U.S. holding corporation to its Japanese parent to ten percent. This reduces the Japanese investor's overall U.S. tax burden to 44.64 percent, the balance of which becomes subject to Japanese corporate and individual tax.

99. Id. §§ 11, 243.
100. Id. § 1441.
In this model, the investors form a U.S. partnership to operate the business, rather than a corporation. The partners, thus, lose limited liability. At the same time, they gain greater flexibility to make special allocations of income, credit, gain, or loss, and there is no taxation at the partnership level since the partnership is a pass-through entity.

1. Nontreaty Investor

a. Capitalization

Section 721 provides for nonrecognition both at the partnership level and to the contributing partner on the contribution of assets to the partnership to the extent the contributing partner only receives the partnership interest.\(^\text{101}\)

b. Effects on the Foreign Investor

This model provides the lowest possible tax burden for the foreign investor, who will be subject to a maximum tax of thirty-four percent in the case of a corporation\(^\text{102}\) and twenty-eight percent in the case of an individual.\(^\text{103}\) Payment of this tax will be secured by twenty percent U.S. withholding on the partnership distributions.\(^\text{104}\) If the actual tax liability is lower, the foreign investor can apply for a refund of the overpayment.\(^\text{105}\) Moreover, because

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\(^{101}\) While this statement is true for income tax purposes, it should be noted that section 1491 imposes an excise tax of thirty-five percent on the excess of fair market value over adjusted basis of any property contributed by a U.S. person to a foreign partnership. It should be further noted that payment of the excise tax will not be an addition to the taxpayer's basis in the property. See Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 226, reprinted in 1976-3 (Vol. 2) C.B. 1; 1976-3 (Vol. 2) C.B. 238. The section 1491 tax may be avoided where the taxpayer elects to recognize gain on the appreciation under section 1057.


\(^{103}\) Id. § 1.

\(^{104}\) Id. § 1446(a).

\(^{105}\) See id. § 1446.
the foreign investor holds the investment directly, there is no branch profits tax liability.\(^{106}\)

By virtue of its direct interest in the partnership, the foreign investor will be deemed engaged in a U.S. trade or business and subject to direct taxation on all income effectively connected therewith.\(^{107}\) This status may also affect other investments the foreign investor may hold or acquire. It should also be carefully noted that the foreign investor will be subject to unlimited liability under this arrangement.

Finally, it should be noted that the partnership form gives the investor the flexibility to make special allocations to the U.S. partner, of what, if the joint venture were in the corporate form, would otherwise be wasted deductions since shareholders cannot allocate deductions among themselves the way partners can. The U.S. partner can use them to offset other income, assuming that the special allocations had substantial economic effect, as provided in section 704(b)(2).

c. Estate and Gift Tax Effects

If the foreign investor's interest in the partnership is deemed an intangible interest, the estate and gift tax provisions may not apply to the disposition of the interest.\(^{108}\) However, in the absence of direct precedent, the foreign investor would be well advised to take the position, for planning purposes, that the interest would be subject to U.S. estate and gift tax.

2. Treaty Investor

There is no applicable treaty provision to reduce the withholding rate below twenty percent.\(^{109}\) Indeed, to the extent that the partnership constitutes a permanent establishment, the Japanese investor will be taxed at a maximum rate of twenty-eight percent.\(^{110}\)

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106. Id. § 884(a).
107. Id. § 875(1).
108. See id. §§ 2101, 2501(a)(2).
110. Id.
In this model, the investors again operate their business in the partnership form but hold their partnership interests through corporations. For the foreign investor, this eliminates not only problems of unlimited liability but those of U.S. estate and gift tax as well.

1. Nontreaty Investor
   a. Capitalization
      As discussed under the preceding model, section 721 provides for non-recognition of the contribution of appreciated property.111
   b. Effects on the Foreign Investor
      In this model, the foreign investor is subject to a thirty percent branch profits tax on the foreign corporate partner's earnings and profits effectively connected with the conduct of a U.S. trade or business.112 The twenty percent withholding tax on gross distributions of effectively connected partnership gains and losses to the foreign corporate partner's corporation113 secures the branch profits tax liability.
      In addition, if at least twenty-five percent of the foreign corporate partner's business is effectively connected with the conduct of a trade or business within the United States for the three year period preceding its payment of a

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111. See supra note 101 and accompanying text.
113. Id. § 1446.
dividend, the foreign corporation is subject to second-level withholding taxes on dividends and/or interest.\footnote{Id. §§ 861(a)(2)(B), 1441.}

Interposing the foreign corporation as a partner limits the foreign investor’s liability. However, the foreign corporation is treated as engaged in business in the United States.\footnote{Id. § 875(1).}

c. Estate and Gift Tax Effects

Since the foreign investor holds stock of a foreign corporation, disposition of the stock is not subject to U.S. estate or gift tax.

2. Treaty Investor

Under the general section 884(e)(4) definition of a qualified resident, so long as fifty percent or more (by value) of the foreign corporation’s stock is owned by residents of Japan, the Japanese corporation is exempt from the branch profits tax.\footnote{Tax Treaty, supra note 75, art. 7 at 981-82, T.I.A.S. No. 7365 at 15-16; see also supra text accompanying note 83.} However, to the extent that the partnership constitutes a permanent establishment, the Japanese corporation will be subject to at most a thirty-four percent U.S. corporate tax.\footnote{Id., art. 8 at 982-84, T.I.A.S. No. 7365 at 16-18.}
In this model, the foreign investor again uses the partnership form to operate the business but interposes a U.S. corporation between the foreign corporation and the partnership as in the previous model, thus eliminating the applicability of both the branch profits tax and withholding tax under section 1446. The U.S. investor continues to insulate himself from unlimited liability by using a corporation as the partner.

1. Nontreaty Investor
   a. Capitalization

   Section 721 provides for nonrecognition in connection with the contribution of appreciated property.\(^{118}\)

   b. Effects on the Foreign Investor

   The foreign investor's combined U.S. tax burden is 53.8 percent: there is no tax at the partnership level or on distributions, thirty-four percent at the corporate partner level, and a thirty percent withholding tax on distribution

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\(^{118}\) See discussion in connection with Model IV, supra note 101, at 4.
of the remaining sixty-six percent to the foreign holding corporation.\textsuperscript{119} The foreign investor may, however, face additional home country taxes at the corporate and individual levels.

The interposition of the U.S. corporation prevents the foreign investor, whether corporate or individual, from being deemed engaged in a U.S. trade or business, avoids the branch profits tax of section 884, and also eliminates the twenty percent withholding on distribution from the partnership.\textsuperscript{120} Dividend or interest payments by the foreign corporation are not subject to the second-level withholding tax, since the foreign corporation is not engaged in a U.S. trade or business.

c. \textit{Estate and Gift Tax Effects}

Since the investor holds stock of a foreign corporation, there is no liability for U.S. estate or gift tax on the disposition of the stock.

2. \textit{Treaty Investor}

As discussed in connection with Model III, article 12 of the Tax Treaty can reduce the rate of withholding tax on dividends paid by the U.S. corporation to the parent foreign corporation to ten percent. Thus, the Japanese investor would bear a total U.S. tax burden of 40.6 percent: thirty-four percent of corporate profits and ten percent on repatriation of the remaining sixty-six percent. The balance would be subject to the Japanese tax regime.

\textsuperscript{119} I.R.C. § 1441 (1986).
\textsuperscript{120} Id. § 1446.
TAXATION OF DOMESTIC JVs

G. Model VII

In this model, since the U.S. investment in the joint venture is through a partnership rather than through a corporation, there is no corporate level tax. Accordingly, U.S. investors bear a minimum tax burden, suggesting that this may be an appropriate structure where the foreign investor is raising venture capital from U.S. sources. Otherwise, this model is identical to the previous model in its effects on the foreign investor.

1. Nontreaty Investor

a. Capitalization

Section 721 provides for nonrecognition on the contribution of appreciated assets to the partnership. To the extent that the foreign corporation contributes appreciated property to the U.S. corporation, section 351 provides for nonrecognition since the foreign corporation holds greater than eighty percent of all of the outstanding stock.

b. Effects on the Investors

A critical feature of this model is that the U.S. investor reduces its tax burden to one level on distributions to the partner. The principles discussed in connection with Model VI apply to the foreign investor's tax liability.
2. Treaty Investor

See discussion under Model VI.

H. Model VIII

In this model, the foreign investor creates a foreign limited partnership, whose general partner is a foreign corporation. Both the U.S. and the foreign investors are limited partners, thereby avoiding both unlimited liability and corporate level taxes.

1. Nontreaty Investor

a. Capitalization

Section 721 provides for nonrecognition of assets contributed by the foreign partnership to the U.S. partnership. Foreign law applies to determine if contribution to the foreign corporate general partner can be achieved tax free.

b. Effects on the Foreign Investor

In this model, the foreign investor is subject to branch profits tax of thirty percent\(^1\) which is secured by a twenty percent withholding on distributions from the partnership to the foreign partnership.\(^2\) This is the result because the foreign corporation will be deemed engaged in a U.S. trade or business through the foreign partnership.\(^3\) Accordingly, the foreign corporation is subject to the branch profits tax.

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1. Id. § 884.
2. Id. § 1446.
3. Id. § 875(1).
c. Estate and Gift Tax Effects

Since the foreign investor holds an interest in a foreign partnership, there is likely no liability for U.S. estate or gift tax, although this conclusion may be subject to some doubt by virtue of the fact that the foreign partnership is engaged in a U.S. trade or business by virtue of section 875(1).

2. Treaty Investor

If more than fifty percent of the stock value of the Japanese corporation is held by "qualified" Japanese residents under section 884(e)(4), the Japanese corporation will be exempted from the branch profits tax by the Tax Treaty.

There is no provision in the Tax Treaty to reduce the withholding tax on distributions from the U.S. partnership to the foreign partnership by virtue of article 7. However, under article 7, the Japanese partnership would be subject to a twenty-eight percent U.S. tax burden.

I. Model IX

In this model, the foreign and U.S. investors operate the business through a foreign corporation. While the foreign investor is exposed to branch profits tax, if the U.S. investor has less than fifty percent in vote and value of the foreign corporation and is engaged in an active trade or business, the U.S. investor is able to defer tax on the foreign corporation's earnings and profits until he sells his stock.124

124. This result follows from the fact that the described ownership structure avoids the hexapede, comprised of accumulated earnings tax, I.R.C. section 581, personal holding company, I.R.C. section 541, foreign personal holding company, I.R.C. section 551, controlled foreign corporation, I.R.C. section 951, foreign investment company, I.R.C. section 1246, and passive foreign investment company, I.R.C. section 1291. The requirement of taxation formed by the hexapede subjects the income of those foreign corporations that come within its ambit to current U.S. taxation. Avoidance of the hexapede generally enables the U.S. investor to defer taxation on his gains until they are repatriated.
1. **Nontreaty Investor**

   **a. Capitalization**

   For the foreign investor, gain recognition for contributions in exchange for stock depends on the law where the corporation is domiciled. For the U.S. investor, contribution will generally result in recognition of gain to the extent appreciated assets are contributed.\(^\text{125}\) In addition, to the extent that the contribution of the U.S. investor requires a reorganization involving his existing holdings, section 367 will likely result in requiring the U.S. investor to recognize gain.

   **b. Effects on the Foreign Investor**

   The foreign corporation will be subject to both corporate and branch profits taxes for a total tax burden of 53.8 percent.

   **c. Effects on the U.S. Investor**

   As a shareholder of a foreign corporation, the U.S. venturer is subject to the provisions of sections 531, 541, 551, 951, 1246, and 1291, which generally require current inclusion unless the investor holds less than fifty percent of the foreign corporation's stock and the foreign corporation is actively engaged in business.

   **d. Estate and Gift Tax Effects**

   Since the foreign investor holds foreign stock, there is no liability for U.S estate or gift tax.

2. **Treaty Investor**

   Assuming the Japanese investor holds at least a fifty percent interest in the foreign corporation, the Japanese treaty will obviate branch profits tax,\(^\text{126}\) but the foreign corporation should still be subject to a thirty-four percent tax,\(^\text{127}\) which would be the total U.S. tax burden.

**CONCLUSION**

The foregoing models are, of course, not exhaustive. Since the life of a trust can exceed that of an individual, trusts sometimes can be a substitute for corporations in order to avoid U.S. estate tax. However, trusts can pose an unwelcome abandonment of control for some investors. Given the planning variables, which as the reader can now see are subject to infinite permutations and combinations, it is possible to achieve as flexible a structure as may be required for investment in the United States.

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\(^{125}\) I.R.C. § 367(a) (1986).

\(^{126}\) Tax Treaty, supra note 75, art. 7 at 981-82, T.I.A.S. No. 7365 at 15-16.

\(^{127}\) Id., art. 8 at 982-84, T.I.A.S. No. 7365 at 16-18.