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International Tax Planning in the Shadow of the Treasury’s Proposed Tax Haven Legislation

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There is no assurance that legislation concerning “tax haven” corporations will be enacted in the foreseeable future, and there is certainly no assurance that, if enacted, it will be in the form of the draft of legislation concerning tax-haven corporations proposed by the Treasury on July 28, 1961. There are, however, precautions that the international tax planner may want to take now, acknowledging that some legislation along the lines of the Treasury’s proposals may be enacted in 1962. If you can, of course, defer new organization for foreign operations until the direction of the legislative winds on this subject is reasonably determinable. However, if you cannot defer new foreign organization or if you are faced with an existing organization, there are plans that you can be making and steps that you can be taking now.

If you must plan now for immediate international organization, consider running two sets of plans concurrently. Plan first for the optimum situation under existing United States tax law, and, secondly, plan for the optimum foreign organization if the Treasury’s proposals should be enacted. Next determine what the United States and foreign tax and other consequences of retreating from the first plan to the second one would be. You may find that you can so arrange your foreign organization now as to be in a good position under the proposed tax-haven legislation without significant sacrifice from an optimum organization under existing legislation. Or perhaps you can organize in such a manner as to retreat to a good position under the proposed legislation with minimum United States tax, foreign tax, and other costs.

Let us review some of the transactions that the Treasury’s proposed legislation brands as “tax-haven transactions” in order to see what sort of organizational changes will allow avoiding such a classification. We know that, under the Treasury’s bill, if a “controlled foreign corporation” has income from “tax-haven transactions,” this income may be included in the gross income of a United States share-
holder owning 10 per cent or more of such foreign corporation. The usual situation relates to a United States corporate parent having a foreign subsidiary or subsidiaries, which subsidiaries, in turn, may have one or more foreign subsidiaries. If income from “tax-haven transactions” is taxed to the United States parent currently even though the foreign subsidiary pays no dividends to the parent, deferral and savings of United States tax formerly available will be lost.

HAVEN HOLDING COMPANY

The classic purpose of the tax-haven or tax-base corporation is to allow a profit pooling from foreign operations. This has often taken the form of a tax-haven holding company owning shares in various operating subsidiaries. It may receive dividends from these operating subsidiaries. We will assume the operating subsidiaries' income has been lightly taxed, perhaps because the country of foreign operation deliberately reduces its corporate income taxes to stimulate investments from abroad. Further, dividends from the operating subsidiaries to the holding company go untaxed or are lightly taxed in the country of its incorporation. If such dividends were, in turn, paid by the holding company to the United States parent, they would be depleted by United States corporate income taxation. In many cases, they are not paid out as dividends to the United States parent, however, but instead are invested abroad in new foreign ventures. The proposed tax-haven legislation strikes at such a stratagem by including in the gross income of the United States parent, dividend income of the tax-haven corporation received from the haven's subsidiaries.

However, even under the proposed legislation the same sort of classic profit pooling would appear to continue to be available from the judicious use of branch operations, which avoid the receipt of dividend income by the haven corporation. Of course, the laws of the proposed base country and country of operation will have to be examined, but most of the haven countries either lightly tax or leave untaxed earnings of a foreign branch. Further, the country of operation usually confines its taxation only to income arising within its borders. For example, assume that a Netherlands corporation with a plant in the Netherlands has a manufacturing branch in Eire operating under Eire's tax exemption program and a sales branch in Switzerland which sells the products of the Netherlands and Eire manufacturing plants.
throughout the world. The income of the sales branch is lightly taxed in Switzerland. The Netherlands will not tax the earnings of the Eire or Swiss branches, and Eire and Switzerland will tax only income from activities within their borders. Thus, profits from all of these activities can be pooled in the Netherlands corporation for investment elsewhere without there being any tax-haven transactions.

If the proposed legislation is enacted, one may find that existing subsidiaries can be liquidated into the haven corporation for subsequent operation as branches without United States or foreign tax impact, and the desired profit pooling thus can be obtained without there being tax-haven transactions. Query, however, whether the liquidation could be construed to result in a "dividend" to the haven corporation and thus constitute tax-haven transaction income that would be taxable to the United States parent.

INTER-SUBSIDIARY LOANS

Existing corporations may also find that, by profit pooling through loans from one of the haven corporation's operating subsidiaries to another, they can, at least for a time, avoid the receipt of dividends by the haven corporation. Of course, these inter-subsidiary loans must be real loans with good probability of repayment. The transfers would be taxable under the proposed legislation if the Commissioner were able to sustain a contention that what has the appearance of an inter-subsidiary loan is, in fact, a dividend to the tax-haven parent and a capital contribution by the latter to the apparent debtor.

PAYMENT OF DIVIDENDS NOW

Serious consideration should be given to payment of dividends from an existing subsidiary to a tax-haven parent before the enactment of any tax-haven legislation. This may mean that dividends from the subsidiary to the tax-haven parent must be paid before January 1, 1962, as this could be the effective date of any legislation. In fact, consideration might be given to payment of the operating subsidiary's entire accumulated earnings at this time to the tax-haven holding company. We rarely will find the operating subsidiary with sufficient cash to make dividend payments in such an amount. However, consider having the subsidiary borrow these funds, preferably from others, but perhaps from the United States parent; or
dividends can be paid to the haven holding corporation in the form of notes. The result may be to accelerate any withholding on dividends imposed by the country where the operating company is located, but the avoidance of United States taxes on the dividend payments to the haven holding company could more than offset any such temporary disadvantage. The operating subsidiaries would pay off the loans or notes in the future as their cash positions warrant.

HAVEN SALES CORPORATIONS

If personal property purchased from a related entity is sold for ultimate use outside the country of incorporation of the controlled foreign corporation, and if it is purchased and sold without incurring costs in "processing, manufacturing, or assembling" equal to at least 20 per cent of the property's sales price, the proposed legislation treats the sales as tax-haven transactions.

The most obvious stratagem attacked here is the purchase of goods by a haven corporation from its United States parent for sale abroad. There would seem to be several approaches to avoid the effect of this provision.

Assume the United States parent merely purchases the haven's requirements of a raw material or finished good and sells these to the haven for the latter's resale abroad. It would appear that the haven could avoid purchasing from a related party by merely paying the United States parent a commission for its activities in purchasing the raw materials or finished goods, title passing directly to the haven corporation from the suppliers. If in addition, however, the United States parent converts the raw materials into a finished good by manufacturing operations, the following plan might be considered. The United States parent would purchase the raw materials for the account of the haven, receiving a commission for these purchasing activities; in addition, the haven would contract with the parent to manufacture the raw materials to the haven's specification. It would appear that the haven might thus avoid the purchase from a related entity that is the basis of a tax-haven transaction.

It should be noted that the proposed law construes as tax-haven sales only those sales made for ultimate consumption outside the jurisdiction where the controlled corporation is domiciled. For some, this may suggest the establishment of separate sales corporations in each of the marketing countries. These could be subsidiaries of a
haven holding corporation or of the United States parent. In the usual case, these separate sales corporations would purchase directly from the United States parent. Profits ascribable to the several sales corporations' activities would most probably be taxable in the country of incorporation, but in most cases the tax would be at a lesser effective rate than the United States rate. Such profits would then be available for expansion of the sales activities, available as loans to ventures abroad initiated by the United States parent or its tax haven holding company, or the sales corporation might decide to branch out itself into manufacturing abroad.

MANUFACTURING OPERATIONS

It was indicated above that if the foreign-controlled sales corporation adds to the value of the product by "processing, manufacturing, or assembling" at a cost equal to at least 20 per cent of the sales price, the sales will not be deemed to result in tax-haven transactions. Here the most obvious approach is to consider "beefing up" the manufacturing operations conducted by the sales haven. This might mean transferring some of the United States manufacturing operations abroad.

Where the sales corporation is now purchasing from a related foreign corporation, consider making the manufacturing operation a branch of the sales corporation or the sales corporation a branch of the manufacturing corporation. Where qualification under the 20 per cent test is marginal, perhaps the purchaser can be persuaded to perform some of the functions such as transportation, which inflate the sales price. In any event, do not just assume that if you do some manufacturing in the sales corporation you are going to meet the 20 per cent qualification on all products sold. The test has to be met transaction by transaction on each product sold and may require some pretty fine cost accounting, which presumably would be subject to review by the Internal Revenue Service.

JOINTLY OWNED SALES CORPORATIONS

For some, another possibility is the avoidance of the proposed legislation's control test by establishing a jointly owned haven sales corporation with an independent United States or foreign corporation. Equal ownership of the stock would avoid the haven's buying from
a "related person" since as the legislation is proposed this requires a more than 50 per cent stock ownership. If the other stockholder is a foreign corporation, the haven corporation may be neither a "controlled" foreign corporation within the definition of the proposed legislation nor a "related person" (as defined) from whom it would be purchasing, and thus the legislation would be avoided on two counts. Mutual agreement as to how to use the accumulated earnings of such a joint undertaking is a practical problem that might arise.

HAVEN PURCHASING CORPORATIONS

Foreign-controlled corporations purchasing for sale to a related party without adding 20 per cent of the sales price by "processing, etc.," are deemed by the proposed legislation to be engaged in tax-haven transactions. The typical purchasing haven corporation buys abroad for sale to its United States parent, perhaps buying the manufactured products of its own foreign subsidiaries or direct subsidiaries of the United States parent. The profit ascribable to these purchasing activities has, until now, been untaxed in the United States.

Consideration should be given to the avoidance of sales to a United States parent by allowing the United States parent a commission for its selling activities and making the sale directly from the haven corporation to the eventual United States consumer. Of course, this is not possible where the United States parent is the consumer and may not be practicable where the United States buyers are so numerous as to make sales directly to them by the haven difficult. An example of the latter situation is the retailer who imports goods through a foreign haven corporation for sale in his shops.

There are, however, situations in which the United States parent is reselling to sophisticated industrial consumers who might be willing to take title to the product abroad, directly from the haven corporation. The question of title passage within or without the United States may be important because section 861 (a) (6) of the Code provides that there is United States source income where foreign goods are sold in the United States. Query, however, whether this haven corporation would be doing business in the United States and thus taxable on these sales though the title passed here if it were merely utilizing the United States parent as a sales agent. United States taxation of the haven purchasing corporation would be even more doubtful if it were located in a jurisdiction having a double tax treaty with
the United States requiring a permanent establishment here before a foreign seller is taxable.

As with sales havens, consider also transferring manufacturing operations abroad to be performed by the purchasing corporation in order to meet the 20 per cent test. This need not necessarily mean that the manufacturing be carried on within the country where the purchasing haven corporation is domiciled. It would be sufficient if the manufacturing operations were carried on by a branch located in a foreign country other than the haven country.

Again, as with the sales havens, consider a joint venture with an independent United States or foreign party. As long as you own only 50 per cent of the purchasing haven corporation, it would not be dealing with a “related person.”

FOREIGN CORPORATIONS

It may be that the tax planner will be faced with the establishment of a corporation to carry on operations both inside and outside the United States and which, at least eventually, will be widely held by United States shareholders. In such a situation perhaps the thing to do is to establish a foreign corporation. Assuming that the stockholdings were sufficiently widely held by United States stockholders, the corporation would be neither a foreign personal holding company nor affected by the newly proposed tax-haven legislation. Operations in the United States would then be carried on by a branch or a United States subsidiary of the foreign parent. Of course, the individual United States shareholders would have to forgo the 4 per cent dividends received credit on United States source income, and in many cases, United States corporate shareholders would forgo the 85 per cent intercorporate dividend received deduction on such income. (Not, however, if 50 per cent or more of the foreign corporation's income had its source in the United States. See section 245 IRC.) Such loss of dividends received credit or intercorporate dividends received deduction would probably be offset by the opportunity to reinvest foreign source income from “tax haven” transactions without being subjected to United States tax.

DIVESTURE OF STOCK

If worst comes to worst, deliberate efforts to break “control” of the foreign corporation might be made by sale of particular
shareholdings in order to avoid the proposed statutory control test. Some United States shareholders may wish to sell their holdings in order to avoid being taxed on income they never received which leaves them hard put to find the cash to meet the United States tax due.

A quirk of the proposed legislation appears to allow a United States stockholder to sell his shares up to the last day of the foreign-controlled corporation’s taxable year and not be subjected to tax on the year’s haven income as long as this stockholder’s sale does not “break control.” That is, if the foreign corporation continued to be a “foreign-controlled corporation” after the stockholder’s sale, he would not have to include in his gross income the tax-haven income of the controlled corporation for the fraction of the year in which he held the stock.

SUMMARY

Of course, the biggest stumbling block to planning at this time is the lack of surety about what the Treasury will finally recommend to Congress in the way of legislative attack on tax havens, and, more importantly, what legislative approach Congress will accept, if any. Even at this writing, there is talk of another Treasury draft bill concerning tax havens. In spite of this uncertainty, the tax planner may well find that he has alternative approaches, one of which seems safer from legislative attack than the other. Moreover, the tax planner may find that he is warranted in taking such action as the payment of dividends from foreign operating companies to tax-haven holding companies before the end of 1961, ahead of a possible effective date of any legislation.