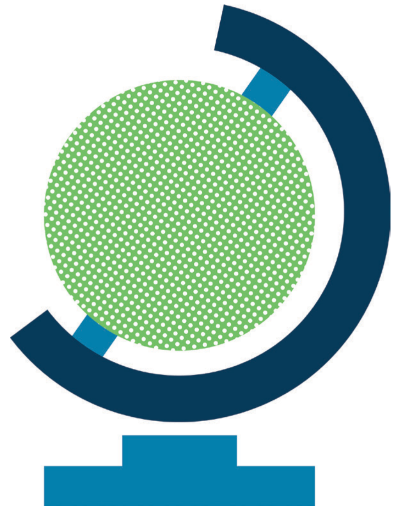
INTERNATIONAL TIDBIT:

Sandwiches Sure to Cause Indigestion for Foreign Investors



Over the last several years, Texas in general, and Houston in particular, have seen growth in investment by foreign companies using our location as a jumping-off point for enterprises elsewhere in the hemisphere from the Arctic to Tierra del Fuego. While U.S. ownership of such investments can offer strategic and commercial advantages along with a convenient home base for global executives, a tax structure involving foreign subsidiaries of a U.S. corporation, whose parent is also foreign, creates the dreaded "sandwich" causing indigestion for tax planners and investors alike.

ORIGINS OF THE SANDWICH

The irony is not lost on Tidbits that some of the companies confronting a sandwich structure are energy ventures based in the U.K. where John Montagu, the 4th Earl of Sandwich and twice the First Lord of the Admiralty in the 18th century, is credited with creating this culinary staple involving two slices of bread with some meat in the middle. In the context of tax structuring, the "meat in the middle" is the U.S., with its maximum corporate tax rate of 35% one of the highest in the world, and making it likely that the "slices of bread" on either side represent countries with significantly lower rates of corporate income tax.

HIGHER TAXES ON EARNINGS

Aligning legal, tax, and managerial structures may appear attractive when a U.S. corporation is the center of a hub-and-spoke strategy for the Western Hemisphere. It can lead to higher taxes if a U.S. corporation owned by a foreign parent holds shares of foreign subsidiaries, as the following example illustrates.

> The current rate of corporate taxation in Ecuador is 22% and in the U.K. is 21%.[i] If a U.S. corporation owned by a U.K. holding company is used to invest in Ecuador, the result will be incremental tax in the U.S. at rates up to 35% when Ecuadorean earnings are repatriated, compared to no additional tax if those earnings could take a detour away from the U.S.

	U.K. Ownership of Ecuador	
	Sandwich	Direct
Ecuador		
Taxable income in Ecuador	100	100
Corporate income tax	22	22
After-tax earnings/dividend	78	78
U.S.		
Dividend from Ecuador	78	
Gross-up for corporate tax paid in Ecuador	22	
Income for U.S. tax purposes[ii]	100	
U.S. corporate income tax at maximum rate	35	
Credit for tax paid in Ecuador	22	
Incremental U.S. tax	13	
After-tax earnings/dividend	65	
U.K		
Dividend from U.S.	65	
Dividend from Ecuador		78
Participation exemption	65	78
Income	0	0
Total tax	35	22
Effective tax rate on income in Ecuador	35%	22%

Where tax rates in Latin America are closer to that of the U.S., for example in Brazil (combined corporate tax rate of 34%), it might be tempting to assume that something close to a full offset of U.S. tax would result if a U.S. corporation owns a Brazilian entity, making a sandwich structure less detrimental. This outcome is not assured because of how the maximum amount of the foreign tax credit usable each year, the "foreign tax credit limitation," is calculated. Foreign corporate income taxes can offset U.S. corporate income tax but only to the extent of U.S. tax on foreign source taxable income. For example, if the U.S. corporation already has a sizeable business and has taken on significant debt to fund its operations, the allocation of interest expense to foreign source income may reduce the foreign tax credit limitation so that less than all the tax paid in Brazil can be used to offset U.S. tax on foreign source income in a particular year.

UNWINDING A SANDWICH

From time to time we encounter companies that have adopted a sandwich structure inadvertently and then want to unwind it when the U.S. tax implications become evident. There are several ways to do this but they all involve exposure to U.S. tax.

In the example, above, the U.K. parent company could have its U.S. subsidiary sell the Ecuadorean company to another subsidiary, such as a Spanish company owned by the U.K. parent company. Not only could this involve taxes in Ecuador on the transfer of shares but could trigger U.S. tax under IRC section 304 (redemption through use of a related corporation), whose application is anything but intuitive to non-U.S. tax planners.

IRC Section 304 would recharacterize the transaction as involving two steps: (1) the U.S. corporation transferred shares of the Ecuadorean company to the Spanish company as a capital contribution (IRC sections 351 and 367(a)) in exchange for shares of the Spanish company and (2) the Spanish company redeemed its shares from the U.S. corporation (IRC sections 302 and 367(b)) by making a payment equal to the purchase price of the shares. While generally the outcome for the U.S. corporation should approximate a simple sale of shares with U.S. tax payable on the gain, the reporting requirements are more complex. If the U.S. corporation sold the Ecuadorean subsidiary or distributed its shares to the U.K. parent corporation, instead of to a non-U.S. subsidiary of the U.K. parent, IRC section 304 would not apply but any gain would still have to be recognized for U.S. tax purposes.

INVERSION EXPOSURE

The transfer of foreign subsidiaries by a U.S. corporation could trigger the dreaded inversion, [iii] within the meaning of IRC section 7874, if the shares of the foreign subsidiaries constitute "substantially all of the properties" of the U.S. corporation. A foreign transferee of the shares could henceforth be treated as a domestic corporation, subject to U.S. tax on its worldwide income, unless an exception to IRC section 7874 applies such as for an active trade or business or an internal restructuring.

While this outcome depends on a number of variables, it reinforces the value of tax planning before setting up a U.S. subsidiary to own companies formed outside the U.S.

[i] Based on information about non-U.S. tax systems provided by International Bureau of Fiscal Documentation.

[ii] Determination of foreign source taxable income would require deduction of expenses related to that income, which can reduce the foreign tax credit limitation.