International Joint Ventures: Selected Practical Considerations

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Philip R. West analyzes various structures of a joint venture where one joint venturer is American, one is non-American and the business is to be conducted outside the United States. The objectives in structuring these arrangements include minimizing U.S. tax on outbound transfers of assets and stock, determining how best to maximize asset basis on acquisition of an interest in the venture, selecting entities and structures that maximize deferral, foreign tax credits and loss utilization, and ascertaining the relevant reporting obligations.

Introduction[1]

In the course of a business' life cycle, its managers may find that they can enhance the business' profitability by joining forces with a previously unrelated business. Both partners may bring complementary assets to the arrangement, but a merger or acquisition may not be justified because the anticipated business advantages extend to only a portion of the entire business of one or both partners. In this circumstance, a joint venture is the logical choice.

But what exactly is a joint venture? Because there is no technical tax definition, the tax consequences of joint venture arrangements must be analyzed with precision. Joint ventures can be structured with corporate entities, partnerships and/or contractual arrangements that may or may not be treated as partnerships for tax purposes. The tax consequences will, of course, differ depending on which entity is used and, as all U.S. tax practitioners know, the legal form of organization may not be determinative of how the entity is treated for U.S. tax purposes.

This article will attempt to clarify these potential sources of confusion while describing significant international tax consequences of organizing, operating and dissolving a joint venture. A preliminary section will discuss the business context in which these tax issues arise.

Except where the context indicates otherwise, this article considers the common fact pattern in which one joint venturer is American, one is non-American and the business is to be conducted outside the United States. It should be noted, however, that U.S. international tax considerations will arise in other situations as well, such as those involving:

- a U.S. venturer and a non-U.S. venturer with a U.S. business;
- two U.S. venturers with a non-U.S. business;
- two non-U.S. venturers with a U.S. business;
- business operations in multiple countries; and
- venturers in multiple countries.

Business Context

Initially, it is appropriate to note the reasons why a business might want to partner with an unaffiliated business. Common catalysts include the need to supplement current operational capabilities to pursue a market opportunity; the desire for market access, capital and/or know-how; risk sharing; and the favorable financial statement impact of operating a deconsolidated business during its start-up phase. In addition, there may be a sense that the time is ripe to move beyond a contractual relationship with a particular business partner, to a stage of operational integration.

It is also useful to highlight at the outset the business-driven facts that the tax advisor must ascertain (and that the tax advisor may or may not have the ability to influence). These "business imperatives" might suggest tax reduction strategies or constrain the planning opportunities available.

Are there nontax reasons why a particular form of business organization is preferred? For example, local law in the country in which the joint venture is to be operated may require that the venture be conducted by an entity that is classified as a *per se* corporation for U.S. tax purposes. This obviously will have ramifications for the tax structuring of the venture.

Does the venture involve a new business or an existing business? If the business already exists, are there business constraints on whether the new participant will acquire its interest from the current owner or through a contribution of assets to the entity that will operate the venture? What particular assets will the parties be contributing to the venture: cash, tangible property, intangible assets, services?

And finally, what tax-relevant, but business-driven geographic considerations will be present? It is the lucky tax advisor who can influence where the business is to be conducted. With respect to where the partners are resident, at best, he likely will be able to suggest jurisdictions for holding entities through which the investment will be made, although he may have more influence over where the entity conducting the venture is organized.[2]

Tax Considerations on Acquisition/ Organization of the Joint Venture

There are several basic tax objectives to be pursued on acquisition or organization of a joint venture. These include minimizing transaction tax costs, maximizing basis of joint venture assets, maximizing operational tax efficiencies, facilitating a tax-efficient exit strategy and meeting compliance obligations.

Achieving these objectives requires the tax advisor to address numerous practical issues. These include determining how best to minimize U.S. tax on outbound transfers of assets and/or stock, determining how best to maximize asset basis on acquisition of an interest in the venture, selecting entities and structures that maximize deferral, foreign tax credits and loss utilization, and ascertaining the relevant reporting obligations.

Transfers of Stock by U.S. Persons to Non-U.S. Corporations

Transfers of stock in non-U.S. corporations can be tax-deferred to the transferor if either the transferor owns less than five percent of the stock of the transferee non-U.S. corporation or the transferor enters into a gain recognition agreement (GRA).[3] In short, the gain recognition agreement requires the transferor to recognize the deferred gain in the event that the transferred stock is disposed of by the transferee non-U.S. corporation within five years of the outbound transfer.[4]

More complex and challenging rules govern the transfer of stock in domestic corporations to non-U.S. transferee corporations. Such transfers can be tax-deferred to the transferor only if the transferor owns less than five percent of the stock of the transferee non-U.S. corporation or the transferor enters into a GRA, the transaction meets two separate 50-percent U.S. ownership tests and the transaction meets an "active trade or business" test.[5]

Transfers of Assets by U.S. Persons to Non-U.S. Corporations

The gain on assets other than stock that are transferred to a non-U.S. corporation generally can be tax-deferred if the assets are transferred for use in the active conduct of a trade or business outside the United States.[6] Some assets have restrictions on their qualification for this favorable treatment, however, while others cannot qualify at all. Importantly, intangible assets (other than non-U.S. goodwill and going concern value) are nonqualified assets for this purpose, and if they are transferred in what otherwise would qualify as a nonrecognition transaction, they are instead deemed to have been transferred for annual payments contingent on their use or productivity.[7]

It is also important to note that, if the transferred assets are assets of a non-U.S. branch, gain must be recognized in the amount of ordinary and capital losses incurred and deducted prior to the transfer. There are, however, numerous limitations on and reductions to the amount of this loss recapture.[8]

Finally, complex rules must be considered which may require the recapture of "overall foreign losses" as well as the triggering of previously "certified" dual consolidated losses when a branch is transferred to a corporation.[9] Similar rules may apply on transfer of a branch to a partnership.[10]

Transfers by U.S. Persons to Partnerships[11]

Prior to August 5, 1997, U.S. rules imposed an excise tax on transfers to non-U.S. partnerships that could be avoided if the transfer was treated as a taxable sale, or if the transferor elected to apply rules similar to those described above for transfers to non-U.S. corporations.[12] On August 5, 1997, however, Congress (1) repealed the excise tax, with the effect that the general nonrecognition of gain rules now apply to transfers to non-U.S. partnerships, and (2) provided the Treasury with regulatory authority to override those nonrecognition rules if future gain on the transferred assets would be includible in the income of a non-U.S. person.[13] The purpose of this regulatory authority is to ensure that property is not first contributed to a partnership and then sold by the partnership under circumstances in which the gain is allocated to a partner other than the contributing partner, such as a non-U.S. partner not subject to U.S. tax.[14] A longstanding provision of the Internal Revenue Code, however, generally prevents the diversion of gains away from a partner that contributes "built-in gain" property to a partnership.[15] Therefore, the Treasury has not yet exercised its regulatory authority in this area.[16]

> There are several basic tax objectives to be pursued on acquisition or organization of a joint venture. These include minimizing transaction tax costs, maximizing basis of joint venture assets, maximizing operational tax efficiencies, facilitating a tax-efficient exit strategy and meeting compliance obligations.

As discussed above, transfers of intangible assets by U.S. persons to non-U.S. corporations generally do not qualify for nonrecognition treatment.[17] Under the rules described in the prior paragraph, however, intangibles could be transferred to non-U.S. partnerships without the recognition of gain. In theory, this should not be troubling if the income generated by the intangible would be taxable on a current basis to the contributing partner in proportion to its share of partnership profits.[18] And, assuming that (1) the other partners have contributed assets to the partnership that also generate a taxable return at a rate similar to the intangibles, and (2) the partners' contributions to the partnership are proportionate to their profit allocation, the partner contributing the intangibles should generate taxable income commensurate with the income generated by the intangible.

Although arm's-length negotiations should, in the typical case, move the partners to seek to satisfy these assumptions in the deal they strike, in practice, the assumptions might not be satisfied, with the result that income from the intangible might not be perfectly reflected in the contributing partner's taxable income from the partnership.[19] For this reason, Congress, in 1997, provided the Treasury with regulatory authority to extend to transfers to partnerships the rules described above governing transfers of intangible assets to non-U.S. corporations.[20] As is the case with the regulations governing outbound transfers to partnerships generally, no regulations have yet been issued under this authority.

Maximizing Basis

To maximize depreciation and amortization deductions, maximize the basis of the assets to be depreciated or amortized. This much is clear. But how is the tax advisor to maximize basis? He is fortunate if the business context allows for the acquisition of the joint venture assets followed by their contribution to the venture. In the typical case, this will bring the basis of the contributed assets to current fair market value, and will thereby enhance deductions.[21]

Even if the business context is not such that the venture's assets can be acquired with a fair market value basis and contributed to the venture, however, it may still be possible to step up the asset bases to fair market value. For example, if one venturer intends to acquire its interest in the venture from another venturer, and the venture is an entity classified as a partnership for U.S. tax purposes, the acquiror's share of partnership asset basis can be stepped up if the partnership has in effect an election to essentially "mark to market" a portion of the basis of the partnership's assets.[22]

If the joint venture vehicle is not a partnership, but is a corporation, the venture may still be able to step up the basis of all or a portion of the venture's assets if the acquiror purchases 80 percent of the venture vehicle and makes an election similar in some ways to the partnership election mentioned above.[23] Under this latter election, a legal fiction is created pursuant to which the acquired corporation generally is deemed to have sold its assets and repurchased them at fair market value.[24]

Special rules apply to the acquisition of intangible assets.[25] These rules were enacted in 1993, when amortization deductions for intangibles were first allowed by statute, and are designed to deter tax-motivated acquisitions of intangibles to step up their basis in situations in which the economic ownership of the intangibles does not substantially change.[26] These "anti-churning" rules will deny amortization of a basis step-up in intangibles acquired after 1993 if the intangibles are acquired from a co-venturer and then contributed to a partnership.[27] The rules can be avoided, however, if the transaction is structured so that first the intangible is contributed to a partnership, and then a partnership interest is acquired from an unrelated venturer, rather than the other way around.

Compliance and Special Rules

U.S. law generally requires the reporting to the IRS of transfers by U.S. persons to non-U.S. corporations.[28] An exception exists for a transfer of stock or securities to a non-U.S. corporation if certain other requirements are met.[29] U.S. law also requires reporting to the IRS of transfers by U.S. persons to non-U.S. partnerships if (1) the transferor owns 10 percent of the transferee partnership immediately after the transfer, or (2) the transferred property has a value in excess of $100,000.[30] For purposes of applying the substantive rules relating to outbound transfers, a transfer by a partnership is generally treated as a transfer by the partners,[31] and a similar rule applies for purposes of determining when reporting is required, except that the rules specifically refer only to transfers by domestic partnerships and reserve on the treatment of transfers by non-U.S. partnerships.[32] For purposes of applying the substantive rules relating to outbound transfers, a transfer of a partnership interest is generally treated as a transfer of the underlying assets[33] and similar rules apply for purposes of determining when reporting is required.[34]

In general, failure to comply with the reporting rules results in a penalty of 10 percent of the value of the property transferred, up to $100,000, unless there is intentional disregard of the rules, in which case the limit is inapplicable.[35] At least in theory, criminal penalties can also apply in cases of willful failure to file the required reporting.[36]

Tax Considerations Relevant to Operation of the Joint Venture

Tax objectives to be pursued in connection with operation of a joint venture include:

- minimizing non-U.S. tax;
- minimizing current U.S. tax by maximizing deferral,[37] foreign tax credits and the utilization of losses;
- anticipating the concerns of any non-U.S. partners; and
- fulfilling compliance obligations.

Techniques for minimizing non-U.S. tax are beyond the scope of this article.[38] The other objectives will be discussed below.

Maximizing Deferral

By definition, direct investment by a U.S. person in a joint venture classified as a flowthrough entity for U.S. tax purposes would require the investor to forego the benefits of deferral. Structuring the joint venture vehicle as an entity that would be classified as a corporation for U.S. tax purposes, however, could significantly reduce the investor's flexibility regarding tax-efficient cash redeployment outside the United States.[39] In addition, as discussed below, direct investment in a corporate joint venture vehicle may be disadvantageous for foreign tax credit purposes.[40]

To retain the benefits of deferral and eliminate some of the disadvantages of operating the joint venture as a directly owned corporation, it may be advantageous to structure the joint venture vehicle as a flowthrough entity, but make the investment in such entity through a wholly owned corporation (or investment holding company).[41] Under such a structure, the U.S. partner could take advantage of the deferral opportunities provided by U.S. law, timing its income inclusions, except for any "subpart F" income earned by the venture.[42]

A fundamental decision under this structure is where to locate the investment holding company. Assuming nontax flexibility, the tax considerations relevant to this decision will include how best to minimize not only net income taxes, but also gross withholding taxes. If the business model is such that the joint venture's earnings will be used either in the joint venture itself or in other businesses directly or indirectly owned by the joint venture holding company (*i.e.*, if the cash need not be repatriated by the holding company prior to further deployment abroad), taxes on the venture may be minimized with a holding company located in the same country as the joint venture. This may be advantageous because the joint venture jurisdiction will not likely impose withholding tax on any distributions from the joint venture entity, and also will commonly impose only a single level of taxation on the joint venture's earnings, either because the structure allows the jurisdiction to regard the joint venture vehicle as a flowthrough or because it allows the jurisdiction to eliminate from taxable income all or a portion of the distributions to the holding company. In addition, as stated above, this structure retains the benefits of deferral because, for subpart F purposes, the investment holding company will be viewed as earning the operating income of the joint venture.[43]

If this structure is disadvantageous, for example because it is not tax-efficient to hold other businesses under a holding company in the joint venture's jurisdiction, total taxes (including income taxes on receipt of distributions from the joint venture, and on receipt of income from re-deployment of the joint venture's earnings) might be minimized through the use of a holding company in a low-tax jurisdiction. Ideally, the selected jurisdiction will not only have low taxes itself, but will also have treaty relationships to protect its residents (and, indirectly, the ultimate investors) from dividend withholding tax in the joint venture's jurisdiction.[44]

Maximizing Foreign Tax Credit Utilization

Classification of the joint venture vehicle as a corporation will mean the loss of credits for the venture's foreign taxes if the investor owns less than 10 percent of the joint venture or is an individual.[45] If a flowthrough vehicle is used for the joint venture, foreign tax credits can be preserved, even if the investor uses a corporate holding vehicle as the direct owner of the joint venture investment.[46] It is important to keep in mind here, as elsewhere, that the entity need not be a flowthrough entity for local law purposes to be a flowthrough entity for U.S. tax purposes.

Structuring to maximize credits not only requires that there be no bar to credits flowing to the U.S. investor, as described in the preceding paragraph, but also requires that the foreign taxes be "basketed" optimally. Basketing refers to the categorization of taxes (and the associated earnings) for purposes of calculating the foreign tax credit limitation.[47]

If the joint venture is a corporation, then even if the investor is a corporate owner of 10 percent or more of the venture, and therefore is not barred from crediting at least a portion of the joint venture's foreign taxes, the investor's share of the venture's foreign taxes and income is placed in a generally unfavorable "non-controlled section 902 corporation" basket (colloquially known as a "10/50" basket) unless the joint venture is a controlled foreign corporation (CFC).[48] The venture might be a CFC because the venturer owns more than 50 percent of the venture, because 10-percent U.S. shareholders own, in the aggregate, more than 50 percent of the venture, or because attribution rules have been used to create ownership above these thresholds as a result of tax planning or business negotiations.[49]

Even if the joint venture is a partnership, unfavorable basketing rules might apply. In the case of a partnership joint venture, all partners (other than individual general partners) that own less than 10 percent of partnership capital or profits at the end of the year have their partnership income classified in the generally unfavorable "passive" basket.[50] Other partners get to "look through" the partnership to basket their partnership income, so that, in general, to the extent that the partnership earns income that is classified in the generally more favorable "residual," or "general," basket, the partner's share of partnership income is also classified in the general basket.[51]

Foreign Tax Credit Utilization: Debt Issues

If the joint venture or the joint venture holding vehicle is a CFC, funding of the CFC's debt by the U.S. parent can adversely affect utilization of foreign tax credits under two different rules: the so-called "CFC netting rule" and a rule that allocates, for purposes of basketing under the "look-through" rules described above, certain interest payments from a CFC first to passive income earned by the CFC.[52]

Even if the joint venture is a directly owned partnership, funding of the joint venture's debt by the U.S. investor can be inefficient as well.[53] First, the interest income will be categorized in the generally unfavorable "passive" basket for foreign tax credit limitation purposes.[54] Second, if the investor funding of the joint venture is itself debt-financed, the investor's foreign source income (which the investor will likely want to keep high for purposes of the foreign tax credit limitation) will be reduced not only by a portion of the partnership's interest expense, but also by a portion of the third-party interest expense.[55]

Moreover, a portion of the investor's interest expense will be allocated to reduce the investor's "general" basket income.[56] This allocation and apportionment of the investor's share of partnership interest expense is carried out pursuant to the following rules. Partnership interest expense that is directly allocable to certain narrow classes of partnership income (*e.g.,* income from assets financed with "qualified nonrecourse indebtedness") retains that allocation in the hands of the partner.[57] Corporate partners that own at least 10 percent of the partnership apportion their share of partnership interest expense on the basis of all their assets, including a *pro rata* share of their partnership assets.[58] Corporate partners that own less than 10 percent of the partnership, as well as individual limited partners that own less than 10 percent of the partnership, allocate their share of partnership interest expense to their share of partnership gross income (which will typically be in the "passive" basket).[59] Individual limited partners that own at least a 10-percent interest in the partnership and individual general partners first classify the partnership interest as business interest, investment interest, passive activity interest or other interest, and then apportion their share of that interest expense in accordance with the allocation rules applicable to such classes of interest.[60]

Overall Foreign Losses

In general, an overall foreign loss (OFL) occurs when the total of the U.S. taxpayer's foreign source losses exceeds the total of its foreign source income.[61] If the U.S. taxpayer has an overall foreign loss in a year, then, in succeeding years, the taxpayer will have to recharacterize an equal amount of foreign source income as U.S. source income.[62] The effect of this recharacterization is that it prevents an amount of foreign source income equal to the amount of foreign source losses that offset U.S. source income from escaping U.S. taxation through the use of foreign tax credits.[63]

A common technique to mitigate the adverse impact of overall foreign losses is to insulate the OFL from the income generating the foreign tax credits sought to be used. Deconsolidation is one way to achieve such insulation, and if an investor group has an OFL preventing the effective use of foreign tax credits from the joint venture, the group might consider deconsolidating the joint venture investment, for example, by arranging for a non-U.S. partner to co-invest in a U.S. corporation organized to own the joint venture investment.

Maximizing Loss Utilization

If the joint venture vehicle is an entity classified as a partnership for U.S. tax purposes, its losses will flow through to its owner. If its direct owner is a U.S. person, that owner will have immediate use of the losses.[64] If, however, as suggested above, the investment is made through a non-U.S. holding company (classified as a corporation for U.S. tax purposes), use of the losses is more complex. In that event, the losses can perhaps most effectively be used to offset income from other investments in flowthrough entities owned by the holding company.

If the joint venture vehicle is an entity classified as a corporation for U.S. tax purposes, its losses can only be used by a U.S. investor, prior to disposition of the investment, in narrow circumstances. For example, the losses of a non-U.S. joint venture classified as a corporation can be used to offset the subpart F income of a subsidiary that it owns if the subsidiary distributes its profits to the loss company such that the subsidiary no longer has earnings and the parent neutralizes the tax effect of the distribution with its losses.[65] As another example, deficits of a CFC that is a member of a wholly owned chain of CFCs might be usable by a higher-tier member of the chain, if the CFCs meet very stringent requirements.[66] Note also that, unlike the case of a non-U.S. partnership owned by U.S. persons, and in the absence of a so-called "double dip" financing structure, interest expense of a non-U.S. corporation owned by U.S. persons reduces only foreign tax of the venture, not U.S. tax of the owner (at least until the U.S. owner has U.S. taxable income from the venture—for example, from actual or deemed distributions—which presumably will have been reduced by the interest expense).

Also relevant to loss utilization are the "dual consolidated loss" rules.[67] Under these rules, certain losses of a "dual resident corporation" cannot be used to reduce the taxable income of another member of the dual resident corporation's "affiliated group." In general, these rules restrict the ability of a corporation that is resident for tax purposes in more than one jurisdiction to use a loss in a U.S. consolidated group if the loss could also be used in a foreign jurisdiction to offset the income of another person.[68] An exception allows the dual resident corporation to use the loss in the United States if it certifies that no portion of the loss has been or will be used to offset the income of any other person under the income tax laws of a foreign country, and it meets certain other detailed requirements, but this certification requires that the loss be "recaptured" upon the occurrence of one of a number of "triggering events."[69]

In considering these rules, it is important to note that a "separate unit" of a domestic corporation is treated as a separate corporation under the dual consolidated loss rules.[70] Branches are included within the ambit of these rules, as are hybrid entities that would otherwise be treated as branches under U.S. entity classification rules.[71] Partnership interests are also covered, and multiple interests in the same partnership may implicate the rule as well.[72] It should also be noted that losses of an entity can carry over to offset its own gains in a later year, and there is a favorable rule that prevents adverse results in the case of multiple branches in the same country.

Inbound Issues

This article primarily addresses issues faced by U.S. investors in international joint ventures. For non-U.S. investors, however, there follows a short checklist of some of the more significant issues they will face when investing in joint ventures operating in the United States.

A fundamental issue to be dealt with by the non-U.S. investor is whether only the joint venture will be subject to tax on the joint venture's undistributed income, or whether the joint venturer itself will become subject to U.S. tax by virtue of the joint venture's activities. This will turn on both the classification of the joint venture vehicle and the application of statutory, common law and treaty principles.[73] Significantly, if a non-U.S. person is required to file a U.S. tax return because it is doing business in the United States, but fails to do so within 18 months of the due date of the return, that person is generally denied all deductions and credits to which it otherwise would be entitled.[74]

In addition to the net taxation of the joint venture's business income, the non-U.S. joint venturer will want to minimize any gross basis taxes collected through withholding (including partnership withholding). Generally, these taxes will apply to payments by a U.S. person to a non-U.S. person that are in the nature of dividends, interest and other similar fixed or determinable annual or periodic income.[75] Because payments by a U.S. branch to its non-U.S. home office would not meet this definition, structuring a U.S. investment in branch form would be an easy way to avoid these taxes if a surrogate tax did not apply. To address this issue, the United States has enacted a "branch profits tax," which applies to remittances or deemed remittances from a U.S. branch to its home office and to remittances or deemed remittances from a U.S. partnership to its non-U.S. partners.[76]

Of course, home country taxation will also be important to the joint venturer, and home country taxation can be drastically affected by the structure of the U.S. joint venture. For example, if the venture is structured as an entity that is treated as fiscally transparent in its home country, the venturer will be taxed on any income of the venture and will immediately reap the tax benefits of any of its losses. Conversely, if the venture is structured as an entity that is treated as fiscally nontransparent in its home country, the venturer will likely be able to defer tax on any income of the venture and will similarly lose the immediate tax benefits of its losses.

The structure of the entity can also affect the extent to which a non-U.S. joint venturer will be taxed on the disposition of the venture. In general, unless the venture is real estate-intensive, the non-U.S. venturer will not be taxed in the U.S. on a disposition of a U.S. corporation, but may be taxed on the disposition of a partnership whose assets are used in a U.S. trade or business.[77]

Compliance

For U.S. venturers in non-U.S. ventures, the reporting obligations can be significant, as can the consequences of failure to comply.[78] U.S. law requires that a non-U.S. partnership file a U.S. information return if it has income "effectively connected" with a U.S. trade or business or if it has U.S. source "fixed or determinable annual or periodic income" and U.S. partners.[79]

Recently revised regulations formerly required that a return be filed by any partnership that had U.S. owners, regardless of whether it had U.S. source or effectively connected foreign source income.[80] Although these rules are no longer operative, reporting is required by U.S. persons who are 10-percent owners of "controlled foreign partnerships."[81] And penalties for failure to comply with the rules are not only $10,000 per year per failure, but also a reduction in otherwise available foreign tax credits from the venture, although the penalty can be abated if reasonable cause for the failure is shown.[82]

The compliance obligations for U.S. persons investing in non-U.S. corporations are similar. For example, U.S. persons that are 10-percent shareholders of controlled non-U.S. corporations and certain other owners of non-U.S. corporations are required to file Form 5471, reporting their interest in and income of the non-U.S. corporation.[83] As above, sanctions for noncompliance include a $10,000 penalty per year per failure and a reduction in foreign tax credits, and an exception exists if reasonable cause is shown for the failure.[84]

Tax Considerations Relevant to Exiting the Joint Venture

The basic tax objectives to be achieved on exiting the joint venture include:

- the minimization of taxable gain or income on the disposition or termination of the interest;
- the maximization of any foreign tax credits that might be available or made available on exit;
- the preservation of any favorable tax attributes of the venture; and
- the fulfillment of relevant compliance obligations.

Minimizing Tax on Winding Up the Venture

A disposition of the joint venture interest by a U.S. taxpayer will generate taxable gain, whether the venture is a corporate entity or a passthrough entity.[85] In many circumstances, a disposition of stock will generate deemed dividend income rather than capital gain and will, therefore, generate indirect foreign tax credits.[86] Depending on the facts, however, disposition of the venture by a non-U.S. subsidiary of the U.S. venturer can produce more favorable results.[87]

The key question in such a case will be whether the disposition by the non-U.S. subsidiary generates subpart F income. Disposition of corporate stock or a partnership interest does generate subpart F income,[88] whereas disposition of assets constituting a trade or business does not.[89] Because, by definition, a joint venture is not conducted alone, a fiscally transparent joint venture will ordinarily be classified as a partnership. But if the co-venturers withdraw from the venture a sufficient amount of time prior to the time the U.S. investor's non-U.S. subsidiary terminates or disposes of its interest,[90] the subsidiary can operate the business as a branch and dispose of the branch assets without generating subpart F income.[91]

One occasionally overlooked issue that must be considered on a termination of a branch is the extent to which currency gain or loss may have to be recognized on a remittance of branch assets to the home office of the corporation of which the branch is a part.[92] The gain or loss is calculated by comparing the *pro rata* amount of home office functional currency basis attributed to the remitted assets to the fair market value of the assets in home office functional currency on the date of the remittance.[93]

Even if subpart F income cannot be completely avoided through a branch disposition, subpart F income can be reduced on sale of a partnership interest as opposed to a corporate stock interest. The earnings of a partnership, which generally should not constitute subpart F income, increase a partner's basis in its partnership interest.[94] The result of this basis increase is reduced gain on sale of the interest compared to a sale of corporate stock, with respect to which no such basis adjustment occurs.

Preservation of Tax Attributes

Tax attributes of a fiscally transparent joint venture flow through to its owners on a current basis. As such, they generally do not present issues relating to preservation of entity-level attributes. Corporate joint ventures, however, do present such issues. If a venturer transfers corporate stock, it will, in general, also transfer away the corporation's tax attributes.[95]

It may, however, be possible to preserve favorable tax attributes if the venture is wound up through a liquidation.[96] But so-called "inbound" nonrecognition transactions have come under scrutiny recently, and both legislative and regulatory proposals have sought to restrict the use of favorable tax attributes in such transactions.[97]

Compliance

U.S. law requires that any U.S. person disposing of an interest in a partnership, or whose proportionate interest in a partnership changes substantially, file a return reporting the same.[98] Among the items required to be reported is "information about all foreign entities that were disregarded as entities separate from their owners … that were owned by the foreign partnership. …"[99] Penalties for noncompliance are $10,000 per failure, with an additional $10,000 for every 30 days after notification of such failure is provided by the IRS.[100] As with other penalties mentioned above, an exception is provided if the failure can be shown to be due to reasonable cause.[101]

ENDNOTES

* The author is grateful for the assistance of John Giles and Jason Slatter. All errors and omissions remain his.

1 For other useful discussions on the taxation of international joint venture operations, *see, e.g.,* Edward C. Osterberg, Jr., *International Joint Ventures: Basic Tax Goals and Structures*, 2001 TNT 78-99 (Apr. 23, 2001); Lowell Yoder, *The Application of Subpart F to Structures and Transactions Involving Partnerships*, 8 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 559 (2002); Jiyeon Lee Lim, *U.S. Tax Issues for U.S. Persons Conducting Foreign Joint Ventures Through Foreign Partnerships,* 8 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 641 (2002).

2 Of course, the jurisdiction of organization of the involved entities may be different from the entity's jurisdictions of business operations and tax residence.

3 *See* Code Sec. 367(a); Reg. §1.367(a)-3(b)(1)(i) and (ii). Section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, except as otherwise noted.

4 *See* Reg. §1.367(a)-8. Although, in general, it should not require immediate taxation, Code Sec. 367(b) may independently apply with its own tax consequences. *See* Reg. §1.367(b)-4. This is because Code Sec. 367(a) and (b) "overlap" in certain cases. For example, they apply simultaneously to transfers in stock in non-U.S. corporations to non-U.S. corporations by U.S. persons.

5 *See* Reg. §1.367(a)-3(c).

6 *See* Code Sec. 367(a)(3)(A); Temporary Reg. §1.367(a)-2T.

7 *See* Code Sec. 367(d).

8 *See* Code Sec. 367(a)(3)(C); Temporary Reg. §1.367(a)-6T.

9 *See* Code Secs. 904(f) and 1503(d), Reg. §§1.904(f)-2(d)(5)(i) and 1.1503-2(g)(2)(iii); Proposed Reg. §1.1502-2(g)(2)(iv)(A)(*4*), (*5*) and (D).

10 *See* Reg. §§1.904(f)-2(d)(5)(i) and 1.1503-2(g)(2)(iii)(5).

11 In general, subject to the discussion below, transfers to partnerships are tax-free. *See* Code Sec. 721.

12 *See* Code Secs. 1491–1493, repealed by Act Sec. 1131 of the Taxpayer Relief Act of 1997 (P.L. 105-34).

13 *See id.*

14 *See* H.R. REP. NO. 105-220, 105th Cong., 1st Sess, 628–29 (1997).

15 *See* Code Sec. 704(c). Recently introduced legislation would expand Code Sec. 704(c) to inhibit partnership loss transfers. *See* American Competitiveness and Corporate Accountability Act (H.R. 5095).

16 It is possible, however, that there are circumstances in which Code Sec. 704(c) would not provide complete protection to the Treasury and regulations may yet be forthcoming.

17 *See* Code Sec. 367(d).

18 *See* Code Sec. 704(c).

19 For example, if one partner contributes the intangible and the other partner contributes cash in order to fund start-up and operations in return for a preferred income allocation, the partner contributing the intangible would not have taxable income commensurate with the income generated by the intangible.

20 *See* Code Sec. 367(d)(3).

21 *See generally* Code Secs. 1012, 167 and 197. Note, however, the discussion below regarding the anti-churning rules applicable to intangible assets.

22 *See* Code Secs. 754 and 743(b).

23 *See generally* Code Sec. 338.

24 This deemed sale is the final transaction of the joint venture vehicle (the target) before its acquisition. Therefore, any gain on the deemed sale would not generate income to the buyer under U.S. CFC rules. *See* Code Sec. 951(a)(1). And if the target is not a U.S. taxpayer, it will have no U.S. tax liability itself from the deemed sale because its tax year closes immediately after the deemed sale and repurchase. *See* Reg. §1.338-10.

25 *See generally* Code Sec. 197.

26 *See* Code Sec. 197(f)(9).

27 *See id;* Reg. §1.197-2(h)(6).

28 *See* Code Sec. 6038B. The Treasury has recently issued new temporary regulations regarding reporting requirements for stock transfers in inversion transactions. *See* Temporary Reg. §§1.6043-4T, 1.6045-3T.

29 *See* Reg. §1.6038B-1(b)(2).

30 *See* Code Sec. 6038(b)(1).

31 *See* Temporary Reg. §1.367(a)-1T(c)(3).

32 *See* Code Sec. 6038B, Reg. §1.6038B-1.

33 *See* Code Sec. 367(a)(4); Temporary Reg. §1.367(a)-1T(c)(3)(ii).

34 *See* Reg. §1.6038B-2(a)(2).

35 *See* Code Sec. 6038B(c).

36 *See* Code Sec. 7203.

37 The effect of the foreign currency rules of Code Sec. 987 should also be considered in connection with minimizing tax on a venture whose "functional currency" differs from that of its owner.

38 The omission should not be taken as a measure of importance. Such techniques can be the most effective way of minimizing worldwide taxation of a joint venture.

39 This result could occur because, in order for the non-U.S. corporation's excess cash to be redeployed to the U.S. investor's other non-U.S. operations, the non-U.S. corporation would have to distribute the excess cash to the U.S. person, potentially resulting in U.S. taxation on the distributed amount.

40 *See infra* discussion at "Maximizing Foreign Tax Credit Utilization."

41 *See generally* Osterberg, *supra* note 2, at ¶14–16.

42 On July 23, 2002, the Treasury finalized regulations (commonly referred to as the *Brown Group* regulations) regarding the subpart F character of income earned by partnerships that have CFC partners. T.D. 9008,

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IRB 2002-33, 335, 67 FR 48020–48025 (July 23, 2002). According to the *Brown Group* regulations, the determination of whether items of partnership income are within a subpart F income category is made at the CFC partner level—*i.e.*, as if the CFC partner had earned the income directly. If a provision of subpart F requires a determination of whether an entity is a related person, or whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, these determinations also will be made at the CFC partner level and not at the partnership level. Exceptions to subpart F income—*i.e.,* the same country manufacturing exception—are determined by taking into account the activities of, and property owned by, the partnership and not the separate activities or property of the CFC. *See* Reg. §§1.702-1(a)(8)(ii), 1.952-1(g), 1.954-1(g), 1.954-2(a)(5)(ii), 1.954-3(a)(6), 1.954-4(b)(2)(iii) and 1.956-2(a)(3).

43 *See* Reg. §1.954-2.

44 Of course, in the absence of such treaty relationships, the holding company may be able to take advantage of payor country laws relieving the withholding tax (such as prevail in the case of intra-EU dividends, as well as in the case of dividends from countries that do not impose a dividend withholding tax).

45 *See* Code Sec. 902(a).

46 *See* Code Secs. 702(a)(6) and 901 and *supra* discussion at "Maximum Deferral."

47 U.S. law limits the foreign taxes that can be credited by a fraction, the numerator of which is foreign source income and the denominator of which is worldwide income, multiplied by the U.S. tax on the income subject to the foreign tax. This limitation is calculated separately for taxes and income that are assigned to one or another of certain specified income "baskets." The baskets act as a constraint on the investor's ability to "cross-credit" foreign taxes in excess of the U.S. tax rate against U.S. tax on income subject to foreign taxes below the U.S. tax rate. *See generally* Code Sec. 904. Recently introduced legislation would reduce the number of foreign tax credit baskets to three. *See* American Competitiveness and Corporate Accountability Act (H.R. 5095).

48 *See* Code Sec. 904(d)(1)(E). The use of foreign taxes placed in the noncontrolled Code Sec. 902 corporation basket will be limited until 2003. *See* Code Sec. 904(d)(2)(c)(iii)(II), amended by P.L. 105-34, effective for tax years beginning after December 31, 2002. After January 1, 2003, dividends paid from noncontrolled Code Sec. 902 corporations will not be separately basketed if the dividend is attributable to post-2003 earnings and profits.

49 *See* Code Sec. 957.

50 *See* Reg. §1.904-5(h)(2)(i).

51 Exceptions to these general rules exist for interests held in the ordinary course of a partner's trade or business, the income on which qualifies for lookthrough treatment even if the partner owns less than 10 percent of the partnership, and for so-called "high withholding tax interest," which is separately basketed even if the partner owns 10 percent or more of the partnership. *See* Reg. §1.904-5(h)(2)(ii).

52 *See* Temporary Reg. §1.861-10T(e); Reg. §1.904-5(c)(2).

53 *See* Osterberg, *supra* note 2, at ¶41–44.

54 If the partnership is domestic, its interest payments to the U.S. investor would not constitute foreign source income at all. *See* Code Sec. 861(a)(1) and 7701(a)(30).

55 *See* Temporary Reg. §1.861-10T(e).

56 *See* Temporary Reg. §1.861-10T.

57 *See id.*

58 *See* Temporary Reg. §1.861-9T(e)(2).

59 *See* Temporary Reg. §1.861-9T(e)(4).

60 *See* Temporary Reg. §1.861-9T(d), (e)(3). Recent legislation would significantly modify these interest expense allocation rules in certain circumstances. *See* American Competitiveness and Corporate Accountability Act (H.R. 5095).

61 *See* Code Sec. 904(f)(2); *see generally* Code Sec. 904(f).

62 *See* Code Sec. 904(f)(1). Specifically, in each succeeding year, the taxpayer will have to recharacterize as U.S. source income, the lesser of 50 percent (or a larger percentage if the taxpayer chooses a larger percentage) of its foreign source taxable income for succeeding years or the amount of the remaining overall foreign loss (*i.e.,* the overall foreign loss which has not been previously recharacterized). *See id.*

63 Recently introduced legislation would provide a similar re-characterization and recapture regime for overall domestic losses. *See* American Competitiveness and Corporate Accountability Act (H.R. 5095).

64 Interest expense of a non-U.S. partnership owned by a U.S. person might be able to be used to reduce both foreign and U.S. tax. Interest expense of a non-U.S. partnership owned by a U.S. person may, however, create a dual consolidated loss if the interest expense could be used to reduce both non-U.S. and U.S. tax. *See* Reg. §1.1503-2(c)(3)(B), (c)(5). If the expense is a dual consolidated loss, the loss cannot be used to offset the U.S. affiliated group's taxable income unless the U.S. group certifies to the IRS that the loss will not be used to offset income in the foreign jurisdiction. *See* Reg. §1.1503-2(b)(1), (g). Even with this certification process, if the U.S. group sells the non-U.S. partnership, for example, the group would have to recapture all or part of the dual consolidated loss used in the United States to offset U.S. taxable income. *See* Reg. §1.1503-2(g)(2)(iii).

65 Care in structuring is important, however, because these techniques do not work in many situations. For example, if a profitable company owns a loss company, rather than *vice versa*, it is much more difficult to reduce taxable income in this manner. If structured properly, however, the technique described in the text can also be used to leverage foreign tax credits. For example, if distributions are made as described in the text, earnings are reduced but foreign taxes are not. As such, on later repatriation of the remaining earnings to the United States, the ratio of taxable U.S. income to creditable foreign taxes can be reduced.

66 *See* Code Sec. 952(c)(1)(C); Reg. §1.951-1(c)(1)(ii).

67 *See* Code Sec. 1503(d); Reg. §1.1503-2.

68 *See id;* Reg. §1.1503-2(a)–(c).

69 *See* Reg. §1.1503-2(g).

70 *See* Reg. §1.1503-2(c)(1).

71 *See* Reg. §1.1503-2(c)(3) and (4).

72 Reg. §1.1503-2(c)(3)(B) specifically defines a partnership interest as being a separate unit and therefore a separate entity to determine whether losses of one entity may offset income of another under foreign law. The regulations do not prescribe different treatment for one or multiple interests in the same partnership. Thus, as written, the regulations suggest that multiple interests in the same partnership would each be treated as separate entities in applying the dual consolidated loss rules. *See generally* Osterberg, *supra* note 2, at ¶50. Commentators have argued that multiple interests in the same partnership should not implicate the separate entity rules except in the case of a hybrid entity, but the final regulations as written do not reflect these suggestions. *See id.*

73 For U.S. tax purposes, partners are considered to be actively engaged in a trade or business in the United States if the partnership is so engaged. *See* Code Sec. 875. If the partnership is considered to have a trade or business in the United States (largely a facts-and-circumstances determination), any income effectively connected with the U.S. trade or business would be subject to U.S. taxation. *See* Code Sec. 882. In addition, if the partnership has a permanent establishment in the United States under an applicable income tax treaty, any income attributable to the permanent establishment will be taxed in the United States. *See generally* U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, arts. 5, 7 (1996) (*hereinafter* U.S. Model Convention).

74 *See* Reg. §1.874-1(b)(1); Temporary Reg. §§1.874-1T and 1.882-4T.

75 *See generally* Code Secs. 871 and 1441.

76 *See generally* Code Sec. 884; Reg. §1.884-1(d)(3).

77 As a general rule, the sale of stock in a U.S. corporation by a non-U.S. person will be exempt from U.S. tax under the Internal Revenue Code. *See* Code Sec. 865(a)(2). *See also*

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U.S. Model Convention, art. 13(5) (1996). If a non-U.S. partner sells his interest in a partnership that is engaged in a U.S. trade or business, the sale of the interest may result in part of any gains resulting from the sale being U.S. source and subject to U.S. taxation. Generally, the amount of a foreign partner's gain from the sale of a U.S. partnership interest which the IRS treats as U.S. source will be the same as the foreign partner's distributive share of the partnership's net gain or loss would have been if the partnership would have sold the assets itself. *See* Rev. Rul. 91-32, 1991-1 CB 107. In addition, Code Sec. 897(g) provides that if the U.S. partnership has a U.S. real property interest, as defined, any portion of the foreign partners' gain attributable to the U.S. real property interest will be U.S. source.

78 The non-U.S. venturer in a U.S. venture also will have reporting obligations, and they will differ from those that apply to U.S. venturers in the same investment. For example, a non-U.S. owner of a U.S partnership doing business in the United States will be required to file a U.S. income tax return. *See* Code Secs. 871(b) and 6012.

79 *See* Code Sec. 6031(e)(2); Reg. §1.6031(a)-1.

80 *See* Reg. §1.6031(a)-1, as in effect prior to December 31, 2000. The new rules of Reg. §1.6031(a)-1(b)(3), limiting the application of the general rule, apply to the tax years of foreign partnerships beginning after December 31, 2000.

81 *See* Code Sec. 6038.

82 *See* Code Sec. 6038(b), (c). If the taxpayer fails to file a return that it is required to file, and if it is found that the failure to file was willful, the taxpayer also could be subject to criminal sanctions. *See* Code Sec. 7203.

83 *See* Code Sec. 6038(b), (c).

84 *See id.;* Code Sec. 7203.

85 *See* Code Secs. 741 and 1001.

86 *See* Code Secs. 316 and 1248; Reg. §§1.902-3(a)(6) and 1.316-1. An actual, pre-sale dividend can accomplish similar results, although additional foreign taxes may be incurred in that case. In either case, attention must be paid to the basket in which the foreign taxes reside. If, as may well be the case, they reside in a noncontrolled Code Sec. 902 corporation basket, their use will be restricted, at least until 2003. *See* Code Sec. 904(d)(2)(c)(iii)(II), amended by P.L. 105-34, effective for tax years beginning after December 31, 2002.

87 In addition, if the venture is a passthrough entity, the distribution of property by the venture to the U.S. venturer in liquidation of his interest is tax-preferred (as compared to cash). *See* Code Secs. 731 and 736(b); *but see* Code Sec. 751.

88 *See* Reg. §1.954-2(e)(1)(i).

89 *See* Reg. §1.954-2(e)(1)(*ii*).

90 The withdrawal of the other partners can result in a deemed termination of the partnership, but such termination should be tax-free to the U.S. investor. *See* Code Sec. 708(b).

91 The so-called "check-and-sell" proposed regulations will need to be considered if finalized, as well as the IRS position, even in the absence of final regulations, on transactions in which a check-the-box election is made for an entity shortly before a sale of an interest in the entity. *See* Proposed Reg. §301.7701-3(h). *See also* CCA 199937038 (June 28, 1999), reprinted as ITA 199937038, 1999 TNT 181-54 (Sept. 20, 1999); FSA 200046008 (Aug. 4, 2000); FSA 200049002 (May 24, 2000).

92 *See* Code Sec. 987; Proposed Reg. §1.987-2.

93 *See id.* Currency gain or loss is also recognized on branch-to-branch remittances. *See* Code Sec. 987(3).

94 *See* Code Sec. 705.

95 Transferred attributes are not necessarily preserved in their entirety for use by the acquiror. For example, if the transferred corporation has net operating loss carryforwards or assets with built-in losses, Code Sec. 382 could limit the use of these attributes if more than 50 percent of the corporate stock is transferred. *See generally* Code Sec. 382. Other attributes, however, can be enhanced on the transfer of corporate stock meeting certain requirements. Under Code Sec. 338, for example, an election can be made on certain purchases of corporate stock in a qualified stock purchase that would increase the basis of the corporation's assets to fair market value. *See generally* Code Sec. 338.

96 The preservation of tax attributes only applies if a U.S. shareholder of the foreign corporation owns 80 percent of the joint venture corporation's stock prior to the liquidation. *See* Code Secs. 332, 381.

97 *See* Proposed Reg. §1.367(b)-7. In 1999 and 2000, the Treasury proposed legislation intended to prevent trafficking in tax attributes. Specifically, the proposals would have marked tax-basis-to-fair-market value, and eliminated corporate tax attributes, when an entity or asset enters U.S. tax jurisdiction. Analogous rules would have applied to the transfer of assets and liabilities, and the Treasury would have been given broad authority to write implementing regulations. Under current law, assets entering U.S. tax jurisdiction likely will have an historical cost basis, and corporations entering U.S. tax jurisdiction retain their tax attributes, including their entire earnings and profits history.

98 *See* Code Sec. 6046A; Reg. §1.6046A-1.

99 *See* Reg. §1.6046A-1(c)(3). Reg. §1.6046A-1 requires reporting on Form 8865.

100 *See* Code Sec. 6679.

101 *See* Code Sec. 6679(a)(1). Criminal penalties may also apply if the failure to report was willful. *See* Code Sec. 7203.