Tax Considerations In Foreign Joint Ventures

by Timothy M. Finnerty and Julia P. Coelho

May 03, 2011

When looking to expand business into foreign markets, U.S. based companies often times compare the benefits of partnering with a foreign partner that is already established in the jurisdiction versus starting a new entity and navigating the business, legal and tax uncertainties of the new jurisdiction on their own. For a variety of reasons, joint ventures have become increasingly popular as a means of penetrating foreign markets, because they offer many advantages over going at it alone in a foreign country, including easier access to foreign markets, sharing of financial risks with the foreign joint venture partner and reduction of the costs of doing business abroad, to name a few. However, there are important business and tax implications that U.S. based companies should be aware of before selecting this business model.

A typical structure for a foreign joint venture entails the transfer of intellectual property to the foreign joint venture in exchange for stock of the venture. Such an exchange between a U.S. individual and a U.S. corporation would generally receive tax-free treatment. In the international arena, however, the same transaction can have very different and adverse tax consequences to the U.S. venturer due to the application of an often overlooked section of the Internal Revenue Code (IRC), §367(d).

Under Section 367(d) of the IRC, if a U.S. corporation transfers intangible property to a foreign venture in the typical structure described above, the U.S. corporation will generally be treated as having sold the intangible asset to the foreign venture in exchange for annual payments that are contingent on the productivity, use or disposition of the intangible asset by the foreign venture. The U.S. venturer is deemed to have received such annual payments (also known as “deemed royalty”), whether or not they were actually received. This deemed royalty accrues throughout the useful life of the intangible asset (not to exceed 20 years) and must be recognized by the U.S. venturer as ordinary U.S. source income.

Despite this unfavorable tax treatment, it is often possible to structure the foreign joint venture so that the transfer of the intangible asset to the foreign venture falls outside the statutory framework of IRC §367(d). The particular tax and business needs of the U.S. venturer doing business abroad should be carefully considered before selecting the best course of action. If you are considering expanding your business in this manner, contact us so that we can help you avoid this often overlooked trap for the unwary.