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# Foreign Sales Subsidiaries

Alan M. Grosman\*

## I. INTRODUCTION

The purposes of this paper are to analyze the factors that should be considered by an American corporation in deciding whether to establish a foreign sales subsidiary and to discuss the advantages or disadvantages of placing such a subsidiary in various geographical locations.<sup>1</sup> This discussion, however, shall be preceded by several comments on the structure that a foreign sales operation may assume.

From a legal point of view, there are two types of foreign sale office: (1) a branch of the home company, and (2) a foreign sales subsidiary—a company fully incorporated under the local law of the foreign country involved.<sup>2</sup> A number of factors should be considered in determining which of these two forms a foreign business enterprise should adopt. First, does the foreign government require local (foreign) incorporation as a prerequisite to (a) an investment

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1. A sampling of the relevant literature in this field includes: R. RHOADES & M. LANGER, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS* (1971); Bardack and Wright, *Corporate and Tax Aspects of European Sales Subsidiaries: A Primer*, 33 THE BUS. LAW. 49 (1977) [hereinafter cited as Bardack and Wright]; J. STEINER & F. VAGTS, *Transnational Aspects of Income Taxation*, in *TRANSNATIONAL LEGAL PROBLEMS* (2d ed. 1976). A wealth of information relating to establishment of foreign sales subsidiaries is available from the U.S. Department of Commerce, including the Overseas Business Reports, in-depth Country Market Sectoral Surveys, and the recent, exhaustive study, INDUS. AND TRADE AD., U.S. DEP'T OF COM., *U.S. EXPORT OPPORTUNITIES TO JAPAN* (1978).

2. An interesting type of agency arrangement, known as "importers/factors," has developed in the United Kingdom. Importers/factors are organizations which provide shipping, forwarding, and customs clearance services. In addition, on behalf of overseas manufacturers, these organizations will warehouse goods, price them for the local market, deliver them anywhere in the United Kingdom, and factor (guarantee) the manufacturer's invoices. The exporter must develop sales, but he can hold inventories and control sales in the United Kingdom through use of importers/factors, thus vitiating the need for subsidiaries. U.S. DEP'T OF COM., *OVERSEAS BUS. REP.*, No. OBR 77-24, *MARKETING IN THE UNITED KINGDOM* 4-5 (1977). See also, M. Getschel, *Setting up Your Foreign Subsidiary*, in [1979] U.S. TAX. INT'L OPERATIONS (P-H) ¶ 7506; C. Schmitthoff, *THE EXPORT TRADE* (5th ed. 1975).

permit or an exchange license, (b) ownership of certain types of property, (c) the conducting of certain types of business, or (d) the granting of financial, tax, or other concessions to a new enterprise? Second, is local equity participation required? If so, what form is best suited to the protection of the relative positions of American and foreign investors? Third, are foreign operations not locally incorporated discriminated against, either in law or in administrative practice? Generally, though not invariably, the answers to these and related questions lead to a decision to establish a foreign sales subsidiary, rather than a branch.<sup>3</sup>

The advantages of establishing a foreign sales subsidiary, rather than a branch office, are outlined below.

First, branch profits may be taxed by the foreign country at a higher rate than those of a foreign sales subsidiary. Moreover, tax difficulties may arise with a branch because there may be no clear-cut segregation of its business from the overseas transactions of the parent company.

Second, branches may be established only upon governmental consent, which may be withdrawn at any time. In contrast, most countries legally recognize locally incorporated subsidiaries, provided that they meet registration and other requirements similar to those imposed on an American corporation wishing to do business in a state other than that in which it is incorporated.

Third, the expense of incorporating abroad is no greater than and sometimes considerably less than the cost of establishing a branch office.

Fourth, the formation of a branch may require disclosure to the foreign government of the world-wide operations of the foreign company.

Fifth, in countries where foreigners are prohibited from acquir-

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3. See P. STRENG, INTERNATIONAL BUSINESS TRANSACTIONS TAX AND LEGAL HANDBOOK (1978) [hereinafter cited as STRENG]; MULTINATIONAL CORPORATION CHECKLIST FOR SUBSIDIARIES (L. Theberge ed. 1975). An American company may staff a foreign sales subsidiary with nationals, third country nationals, and United States citizens. In deciding which "mix" of employees is appropriate, the American firm should consider the compatibility of the national with the product marketed, local labor laws, and, particularly with regard to American employees, the costly tax effects of the provisions of the Foreign Earned Income Act of 1978. This Act terminated the exclusion of foreign earned income from gross income and deductions for excess foreign living costs. These new tax provisions require careful study. See Burge, *Impact of the Tax Reform Act of 1976 on Americans Working Abroad*, 6 DEN. J. INT'L L. & POL'Y 647 (1977); *Explanation of Revenue Act, Foreign Earned Income Act*, in [1978] 62 FED. TAX GUIDE RPTS. (CCH).

ing real estate, a locally incorporated company may be permitted to make such acquisitions.

Sixth, a foreign sales subsidiary can serve as a holding company for affiliated companies outside the United States.

Seventh, an overseas affiliate can serve as a source of foreign financing for overseas operations of American companies.

Eighth, foreign affiliated companies, particularly joint venture companies, can accumulate profits abroad, can transfer profits from one foreign operation to another (in the process of building up capital), and, if they are not controlled foreign corporations, can indefinitely defer United States taxes on offshore profits.<sup>4</sup>

## II. WHERE TO LOCATE A FOREIGN SALES SUBSIDIARY

Important factors in deciding where to establish a foreign sales subsidiary include the character of the potential market (including the likelihood of product acceptability in the local marketplace), transportation and communication facilities, transportation costs, financial services, labor supply, the internal tax structure, the cost of relocating American personnel, the nature of the local courts, ancillary business services available, the attitude of the foreign host government and populace, the political environment and its stability, and currency and exchange regulations imposed on the repatriation of profits.

### A. EEC Sites

#### 1. United Kingdom

There are no particular restrictions on the establishment of foreign sales subsidiaries in the United Kingdom, except that it is necessary to obtain the approval of the British Treasury. The British government maintains the country's traditionally liberal attitude toward foreign trade. The government does not impose unusual qualifications on directors and shareholders. Nor do any limitations exist on foreign acquisition of real or other types of property.

It is even possible to obtain financial assistance from the British government in establishing a sales subsidiary, provided that the subsidiary is not designed primarily to serve local needs, as in the case of a retail store. However, the availability of financial assistance is conditioned on the creation of jobs for British nationals. When aid

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4. STRENG, *supra* note 3, at 9.

is desired, it may therefore behoove the parent company to establish a foreign subsidiary that will service the European Economic Community (EEC) as a whole.

Work permits are usually issued for directors of branches or subsidiaries of American firms and for employees of managerial status. American nonresident employees only temporarily employed in the United Kingdom may open "nonresident" sterling bank accounts into which they can deposit their net earnings. Funds from such accounts may be sent to the United States. However, since 1945, American employees residing in the United Kingdom have been subject to British tax laws.<sup>5</sup>

The general policy of the British government is to welcome direct investments, provided that they are appropriately financed. In most cases, this means paying for fixed assets with dollars or other foreign currency.

Although the Companies Act of 1948 permits the organization in the United Kingdom of branches of foreign corporations, in practice, most American firms doing business in the United Kingdom have established subsidiaries known in Great Britain as "private companies." The private company, under British law, can have no more than fifty shareholders. The company's directors may refuse to register any transfer of shares without disclosure of the transferor's intent and prohibit any invitation to the public to subscribe for any of the company's shares or debentures. Every private company must have at least one director and an officer occupying the position of secretary, neither of whom need be a shareholder.

Earned profits and dividends can be remitted regardless of amount, together with any capital gains. Permission from the Bank of England is required for such remittances, but only to make sure that the profits and dividends have been earned and that adequate provision has been made for any liabilities in Great Britain.

In recent years, European Community governments (particularly the British government) have shown increasing interest in intercompany transactions. Their objective is to prevent the exportation of profits from the United Kingdom to other countries through artificial intercompany pricing arrangements or through ex-

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5. Convention between the United States and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, April 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546, *reprinted in* [1980] 2 TAX TREATIES (CCH) ¶ 8103.

cessive interest, royalties, or management charges. Moreover, EEC countries wish to insure that all goods and services sold to or purchased from overseas affiliates are not priced under value or over value, respectively, to minimize the foreign affiliate's realized profit. This investigative interest in requiring "arm's length" pricing in intercompany transactions is carried on under the provisions of Section 485 of the Inland Revenue Act, which is quite similar to Section 482 of the U.S. Internal Revenue Code.

In summary, the United Kingdom, taking into account its liberal attitude toward foreign trade, its highly developed facilities for international trade (London being one of the leading financial centers of the world), and its membership in the EEC, is an attractive location for a foreign sales subsidiary.

## 2. The Netherlands

Internationally oriented companies often decide to form a sales subsidiary in the Netherlands for tax reasons. For example, under the Dutch tax laws, the profits of such subsidiaries are mildly taxed. Moreover, company losses may be carried back one year or carried forward six years following the year in which losses are sustained, and if a loss is incurred during the first six years of a company's existence, it may be carried forward indefinitely. Additionally, Holland is a party to treaties intended to avoid double taxation which reduce foreign withholding taxes on investment income payments (dividends and interest) to Dutch companies and reduce the tax rate (twenty-five percent) on dividend payments to foreign shareholders of a Dutch company. The Netherlands-United States Tax Treaty reduces the rate of tax on dividends to five percent if at least twenty-five percent of the capital of the foreign company is owned by a Dutch company.

The Netherlands is a desirable country to establish a subsidiary in for other reasons as well. For example, the country offers excellent lines of communication and a full range of legal, accounting, marketing, and banking services.<sup>6</sup> Moreover, the Dutch market is compact, homogeneous, and easily accessible. The Netherlands is

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6. The volume of United States exports to the Netherlands is quite high. In 1977, total Dutch imports amounted to \$45.7 billion. Of this amount, more than \$4.7 billion was attributable to the influx of American goods, including transshipments. U.S. DEP'T OF COM., OVERSEAS BUS. RPT., NO. OBR 78-30, MARKETING IN THE NETHERLANDS 3 (1978).

one of the most densely populated countries in the world. Distances are short, and transportation is excellent by road, rail, and water.

An August 1978 marketing report of the U.S. Department of Commerce observes:

The Netherlands has also become the European base of operation for a substantial number of U.S. firms. These subsidiaries act as sales agents, assemblers, or manufacturers of the firm's products. In many instances, the subsidiary is a combination of all three. Such firms import for warehousing against future sales in the Netherlands and other parts of Europe, for servicing products of the parent company, for assembly and sale, or for manufacturing.<sup>7</sup>

As of March 1976, some 1,030 foreign industrial companies had formed wholly-owned subsidiaries in the Netherlands. About 430 had participated in Dutch companies or set up joint ventures. Many American firms have established sales subsidiaries in the Netherlands, mostly with the intention of covering the entire European market.

### 3. The Netherlands Antilles

The Netherlands Antilles, a semi-autonomous, six-island state in the Caribbean, forms part of the Kingdom of the Netherlands. The Antilles consist of the ABC islands of Aruba, Bonaire, and Curacao, and the Windward Islands of St. Eustatius, St. Maarten, and Saba.

The Antilles government welcomes foreign-based enterprises and has provided a range of investment incentives aimed at developing the ABC islands as international distribution centers. These incentives include favorable tax treaties. The government's receptive attitude toward the establishment of foreign subsidiaries—and consequent growth of foreign business activity in the Antilles—has resulted in the development of local banking and other support services.<sup>8</sup>

Free zones like the American Foreign Trade Zones were instituted by government decree in 1956 to promote use of the Antilles as an international distribution center. In these zones, which exist on Aruba and Curacao, goods can be imported, assembled, exhib-

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7. *Id.* at 9.

8. TOUCHE ROSS INTERNATIONAL, BUSINESS STUDY: NETHERLANDS & NETHERLANDS ANTILLES 189, 199 (1977).

ited, and re-exported duty-free, provided that the product has not been substantially changed during the packaging and assembly process. In the free zones, customs formalities and charges are minimized. Warehouse and assembly sites are available on advantageous terms. Additionally, because the Antilles are an associate member of the EEC, goods produced in the islands can be exported to the large EEC market duty-free. In this context, "produced" means processed in the Antilles from imported materials or parts. Value must be added to the product in the Antilles. Before a foreign firm undertakes any operations in the Antilles, it should obtain a governmental definition of what constitutes goods "produced" in the Antilles. The mere breaking of bulk in the Antilles would *not* give those goods duty-free access to the EEC market.

In summary, tax benefits, good banking facilities, professional services, and excellent communications make the Antilles an attractive base for the establishment of foreign sales subsidiaries.

#### 4. West Germany

The strong economy of the German Federal Republic and its central position in European markets continue to be major factors in attracting foreign investment. At the beginning of 1974, foreign long-term investments amounting to nearly fifty billion Deutsche Marks were held in over 11,000 commercial enterprises, with about seventeen percent of all sales derived from such investments. In 1974, American firms held forty-three percent of the total amount invested in West Germany by foreign firms.<sup>9</sup>

The German government encourages foreign investment and trade. The Foreign Trade Law of 1961 provides that foreign trade must be unimpeded unless special reason exists for imposing restrictions, and that such restrictions, if imposed, must be lifted when their justification is no longer operative.<sup>10</sup>

A foreign firm may conduct its business in Germany through a branch or subsidiary without German participation in ownership or management.<sup>11</sup> The American firm may acquire or invest in an ex-

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9. TOUCHE ROSS INTERNATIONAL, BUSINESS STUDY: FEDERAL REPUBLIC OF GERMANY 9 (1976) [hereinafter cited as TOUCHE ROSS]. See also U.S. DEP'T OF COM., OVERSEAS BUS. RPT., No. OBR 77-62, MARKETING IN THE FEDERAL REPUBLIC OF GERMANY AND WEST BERLIN (1977).

10. TOUCHE ROSS, *supra* note 9, at 11.

11. Walter, *Legal Aspects of Doing Business with the Federal Republic of Germany*, 18 FAIRLEIGH DICKINSON UNIV. BUS. REV. 14-20 (1978).



isting business or enter into a joint venture. Repatriation of capital, dividends, interest, license fees, and royalties can be effected, without limitation, through any bank. And foreign nationals are free to buy and sell securities, land, and any other form of property.

All of the foregoing factors make Germany a desirable location for setting up a foreign sales subsidiary.

### *B. The Middle East*

Beirut was a most successful regional sales center before business activity was disrupted several years ago by Lebanon's civil war. A foreign subsidiary in Beirut had all the necessary facilities and resources at its disposal: banking, foreign exchange, telex, financial services, and trained personnel. Since the outbreak of the civil war, Athens, Amman (Jordan), and Tel Aviv have sought to attract foreign business that would otherwise flow to Beirut by developing similar facilities and services. As of this date, Athens<sup>12</sup> and Amman are viable sites for regional sales operations in the Middle East.

One of the incentives provided by the Greek government to stimulate location in Greece is Emergency Law 89/1967. This law is applicable to Greek-situated branches of foreign organizations if the branch is a headquarters or nerve center for conducting business outside Greece and the branch does not do business in Greece. Branches subject to this law may exclude all income from Greek income tax and from all other Greek taxes, including turnover tax, import duties, and all other charges on imported equipment for the operation of the management branch.<sup>13</sup>

Jordan's efforts to attract foreign business are summarized in a December 1977 U.S. Department of Commerce publication:

The Jordanian Government has made particular efforts to de-

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12. The U.S. State Department has observed the desirability of locating in Greece: Greek business representatives, traditionally active in the Middle East, have sharply increased that activity recently. Greek exports to the Middle East and North Africa increased from \$50 million in 1972 to \$500 million in 1977. . . . Athens continues to grow as a regional trade center for the Middle East. Nearly 300 international businesses, two-thirds of them American, now maintain Middle East regional offices in Athens.

U.S. DEP'T OF STATE, BACKGROUND NOTES NO. 8198, GREECE 7 (1978).

13. U.S. DEP'T OF COM., OVERSEAS BUS. RPT., NO. OBR 78-25, MARKETING IN GREECE 23 (1978). Greece's Investment Law 2687 of 1953 protects foreign investment and provides for remittance of equity and loan capital, earnings, and transfer of royalties in foreign exchange. For recent developments, see U.S. DEP'T OF COM., FOREIGN ECONOMIC TRENDS AND THEIR IMPLICATIONS FOR THE UNITED STATES, PUB. NO. 78-051, GREECE 4-8 (1978).

velop Amman as a regional business center for the Arab world. Amman's central location, good communications, and pleasant living and working conditions have made it a natural choice for some of the firms which would otherwise have been headquartered in Beirut but could not due to the civil war conditions there. The Registration of Foreign Companies Law No. 46 of November, 1975 clarified, codified, and enlarged upon incentives for foreign firms to set up regional headquarters in Amman. The law relates only to firms setting up regional offices for the conduct of business *outside* Jordan. . . . Since the issuance of this law, about 130 firms have established Middle East headquarters in Amman, including over 30 American firms.<sup>14</sup>

### C. Japan

In setting up a sales distribution network in Japan, the American firm should consider three strategies: (1) exporting through a Japanese trading company, (2) indirect sales through distributors, or (3) entering into a joint venture with a Japanese company.

It is advantageous for an American company to enter into a joint venture with a Japanese manufacturer or trading company to gain access to the Japanese partner's distribution network. The reputation of the Japanese company and its product, together with the company's capital and sales capacity, can help sell American goods. In addition, certain products can be marketed in Japan by means of a franchise system, with the joint venture as its base.

Volvo of Sweden is a recent example of a successful foreign-Japanese joint venture. As part of its new aggressive sales policy, Volvo, in 1974, stopped marketing its cars through local importers and distributors and set up a joint venture with a Japanese corporation. Teijin-Volvo Kabushiki Kaisha was established in April 1974 as a "50-50" capital subscription joint venture, capitalized at 200 million yen. In 1976, Volvo's sales surpassed those of 1975 by forty-six percent.

## III. LOCAL PARTICIPATION

The United Kingdom, the Commonwealth countries, France, Belgium, the Netherlands, Israel, Austria, and the Federal Republic of Germany do not compel local equity or management participa-

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14. U.S. DEP'T OF COM., OVERSEAS BUS. RPT., NO. OBR 77-67, MARKETING IN JORDAN 26-27 (1977). See also U.S. DEP'T OF COM., FOREIGN ECONOMIC TRENDS AND THEIR IMPLICATIONS FOR THE UNITED STATES, PUB. NO. 78-067, JORDAN 8 (1978).

tion in foreign subsidiaries. In contrast, a number of other countries require that the majority of shares in a foreign enterprise be held at least nominally by nationals. In Spain, for example, seventy-five percent of the capital of a foreign subsidiary must be locally owned. In Mexico, fifty-one percent of the share capital must be owned by nationals. Sweden and Finland require that nationals own eighty percent of the total capital. Moreover, Sweden imposes a bar on the transfer of locally owned shares to aliens and requires that all of the organizers of the company be resident nationals. In Denmark, a majority of the organizers must be resident nationals or other persons who have resided in Denmark for at least five years. In a number of countries, all or a majority of the members of the board of directors must be resident nationals of the respective country.

Even if the foreign sales subsidiary can be wholly owned and controlled by its American parent, certain considerations may make local participation desirable: capital resources may be expanded, the risk of hostile treatment by the host government can be minimized, the risk of expropriation can be reduced, and nationals may assume roles as technicians, managers, and administrators.

#### IV. CONCLUSION

This article has explored the various tax and tactical advantages of setting up a subsidiary. Regional and national sales offices should be explored, depending on the market area that has been targeted and the incentives of the local government to restrict sales activity to or expand it beyond the national market. Finally, as this article has pointed out, no sound reason can be advanced for not having local participation in the enterprise, even though the foreign firm may understandably wish to retain exclusive ownership and control.