

Important Tax Considerations for U.S. Companies Doing Business Overseas

by Sean M. King & Matthew C. Marshall

The expansion of any business poses numerous hurdles, but the expansion of an operation overseas can create unique challenges that may impact the financial viability of the enterprise. One such challenge is taxation. As this article will discuss, any U.S. company with emerging overseas operations will face significant tax issues in order to mitigate multiple layers of taxation. While the primary international tax regulations that are imposed on U.S. corporate taxpayers can be daunting, they can also be managed if careful planning consideration is undertaken at the outset of the overseas expansion. Better still, proactive international tax planning can actually result in a lower global effective tax rate. This article will explore the challenges, pitfalls and opportunities associated with expanding a business overseas in a tax efficient manner.

The Challenge

U.S. multinational companies (“U.S. Multinationals”) are U.S. based companies with foreign activities. (For example, a United States corporation with a subsidiary in Canada). Conversely, Foreign multinationals (“Foreign Multinationals”) are foreign based companies with activities outside of the country where they are based. (A Canadian corporation with a subsidiary in the United States). As we will explore below, U.S. Multinationals face Federal income tax compliance challenges not necessarily faced by Foreign Multinationals.¹

The disparity between U.S. Multinationals and their foreign competitors, who may also be multinationals, exists principally because the U.S. has a worldwide income tax system that taxes a U.S. Multinational on its worldwide income as opposed to only taxing income from U.S. sources. In contrast, many foreign countries do not have a worldwide income tax system; they only tax their multinationals’ domestic source income and not foreign sourced income.

In addition to being taxed at home and abroad on foreign source income, a U.S.

Multinational will face another layer of U.S. income tax when it repatriates to the U.S. income accumulated in a foreign subsidiary. Therefore, U.S. Multinationals need to concern themselves with three layers of tax on their foreign source income: (1) foreign income tax in the local country where the income is earned, (2) withholding taxes that may apply upon the payment of a dividend or other income stream from the foreign subsidiary to the U.S. parent, and (3) U.S. income tax on foreign sourced income accumulated in a foreign subsidiary when the foreign sourced income is repatriated to the U.S.

Taxable Presence Outside of the United States

A first consideration for any U.S. Multinational is whether the company’s expansion outside of the U.S. will give rise to a taxable presence in the local country. Similar to the state tax concept of “nexus,” in the cross-border context a “permanent establishment” can be created local country when the enterprise reaches a certain level of activity. This concept is not defined in the Internal Revenue Code but is the product of the relevant tax treaty between the United States and the local country. The creation of a permanent establishment in the foreign country is problematic because it exposes the U.S. Multinational to taxation in the foreign country. Care should be exercised when evaluating possible permanent establishment risk because a U.S. company that does not consider itself to have a taxable presence in the local country can inadvertently establish a permanent establishment there. For example, a U.S. retail chain with no plants or subsidiaries outside of the U.S. may acquire product in China. To procure the retail items, the company may employ “dependent agents” in China. Employing a dependent agent in the other country can give rise to a permanent establishment under the applicable income tax treaty. In this case, if the U.S. company has created a

permanent establishment in China, it will likely be required to file an income tax return in China and pay Chinese income tax on its Chinese activities. This is problematic for three reasons: First, the U.S. Multinational has now opened itself to the jurisdiction of the governmental authorities in the local country. Second, many local countries take a nationalistic view of the value of services performed in their country. As such, the allocation of income between the U.S. and that country may be artificially and arbitrarily skewed in favor of the local jurisdiction. Third, the statute of limitations in many countries does not begin to run until the taxpayer has filed an income tax return. Thus, the failure to file an income tax return means that the taxpayer has an “open year” for an indefinite period in which the foreign country may assess it with income tax. This can result in significant FIN 48 consequences.²

In order to avoid permanent establishment risk, many U.S. Multinationals choose to operate overseas through a formal corporate subsidiary, which reduces the U.S. Multinational’s foreign income tax exposure even though it may result in an additional level of foreign income tax on the subsidiary’s earnings. In this situation, U.S. Multinationals must choose the business form in which to operate in the foreign country. In most jurisdictions, U.S. Multinationals can operate in the foreign country as a branch, a pass through (e.g., partnership), or a corporation. As a branch, the U.S. Multinational does not create a subsidiary in the foreign country. The U.S. Multinational holds assets, employees and bank accounts under its own name. With a pass through, the U.S. Multinational creates a separate entity in the foreign country that is treated as a partnership under the tax law of the foreign country and is treated as a partnership or is disregarded under U.S. tax law. If the U.S. Multinational operates as a partnership or branch in the foreign country, the items of profit, loss, deduction and

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credit realized in the foreign country flow through to the U.S. Multinational who pays foreign income tax on the profit. Consequently, there is only one level of foreign income tax when the U.S. multinational operates as a branch or pass through in the foreign country. U.S. multinationals can also create corporate subsidiaries in the foreign country that are treated as corporations under the tax law of both the foreign country the U.S., with possibly two levels of income taxation in the foreign country plus U.S. income taxation of earnings repatriated to the U.S. as dividends. Under the U.S. foreign tax credit regime, the U.S. Multinational will be entitled to a credit for taxes paid by the subsidiary in the foreign jurisdiction. It should be noted, however, that the foreign tax credit is subject to a limitation such that no credit will be granted for taxes paid in excess of the amount of tax that would have been paid if that same item of income had been earned in the U.S. In other words, certain credits may not be utilized, thereby leaving the U.S. corporate taxpayer in an "excess credit" position. Moreover, the foreign tax credit is determined by a complex formula that encompasses the U.S. Multinational's worldwide tax position, not just its tax position in one foreign country. Due to high levels of taxpayer error in foreign tax credit calculations, the IRS heavily scrutinizes U.S. Multinational's foreign tax credit reporting.

Finally, under the U.S. entity classification rules, certain types of entities can "check the box" to elect their classification to be taxed as a corporation with two levels of tax, a partnership with pass through taxation, or even disregarded for U.S. federal income tax purposes. The check the box election allows U.S. Multinationals to engage in more effective global tax planning. For example, the U.S. Multinational can have a foreign subsidiary treated as a corporation under the laws of the subsidiary's jurisdiction, while the subsidiary can file a check the box election to be treated as a pass-through entity for U.S. tax purposes. This can be a common planning approach when a new overseas operation is in its infancy. The U.S. Multination might expect the new enterprise to experience typical growing pains for the first few years of the operation. As such, any losses that are generated at the level of the subsidiary can

flow through to the U.S. parent entity to be used to offset U.S.-level gains.³

Transferring Assets to the Foreign Enterprise

When establishing a foreign corporate subsidiary, the U.S. Multinational will likely need to transfer certain assets to the new entity in order for that enterprise to become fully operational. However, in many cases, the U.S. Multinational cannot transfer certain assets to the foreign corporate subsidiary without recognizing taxable income. This is in contrast to the transfer of property to a U.S. corporate subsidiary which is usually tax free to the parent corporation under section 351 of the Internal Revenue Code. In the international context, the IRS likes to preserve its bite at the apple by imposing certain outbound "toll charges" on the transfer of appreciated property to a foreign entity. These toll charges are usually provided for in section 367 of the Internal Revenue Code and are subject to various exceptions and nuances. Accordingly, great care should be exercised when contemplating any such outbound transfer.

In order to avoid gain, the U.S. Multinational may prefer to license intellectual property to the foreign subsidiary for a fee rather than transfer the property outright. However, licensing requires the Multinational and the overseas subsidiary to adhere to transfer pricing rules, as dictated by section 482 of the Internal Revenue Code. Simply put, these transfer pricing rules require the U.S. Multinational and the foreign subsidiary to interact in an arms-length manner with regards to pricing and economic terms. Transfer pricing rules aim to prevent companies from artificially shifting income from a high tax jurisdiction to a low tax jurisdiction and ensuring appropriate transfer pricing compliance is a high priority for most taxing authorities, including the IRS. Furthermore, any such arrangement may attract withholding taxes when royalties are paid across a border. Many of the comprehensive income tax treaties to which the U.S. is a party provide for reduced (or eliminated) withholding taxes on royalty arrangements. Accordingly, an appropriate assessment of treaty applicability is imperative before entering into such a structuring alternative.

Anti-Deferral

As noted herein above, U.S. Multinationals are generally subject to tax on their foreign sourced income only when that income is repatriated to the U.S. As such, certain U.S. Multinationals may wish to simply defer the income recognition at the U.S. level. In doing so, they would make the treasury management decision to simply leave overseas profits outside of the U.S. without repatriating any of the earnings to the U.S. until a later time. In principle, this income could "pool" or otherwise remain offshore indefinitely without ever causing a U.S. income inclusion. In fact, this form of deferral planning is usually the impetus for company's creating non-U.S. holding companies in a tax advantageous jurisdiction where the income is subject to a low rate of taxation and is effectively "blocked" from being taxed in the U.S.

Despite general merits of this form of planning, U.S. Multinationals will be subject to the primary anti-deferral mechanism of the Internal Revenue Code, commonly known as the "Subpart F" regime. Under this regime, if the foreign corporate subsidiary has 50% or greater U.S. ownership, it will be a "controlled foreign corporation" ("CFC"). U.S. shareholders of CFC's recognize their pro rata share of certain types of the CFC's foreign income at the time the CFC earns the income instead of waiting until a later date when the CFC repatriates the income to the U.S. as a dividend. Subpart F income is generally passive in nature and includes dividends, interest, rent and royalties. A U.S. Multinational's inclusion of Subpart F income in its gross income can cause timing problems. For example, if a Japanese CFC earns interest income in Japan in year one, it's U.S. Multinational parent will recognize its pro rata share of the interest income as U.S. gross income in year one. If the CFC does not repatriate the interest income to its parent until year two or later, the parent is left in year one paying U.S. income tax on foreign income without the benefit of having repatriated cash in year one with which to pay the tax. As such, Subpart F income should be carefully considered when engaging in enhanced or more creative international tax planning.

International Tax Legislation Under Consideration

Many of the rules discussed in this article above may become obsolete under a variety of proposals currently under consideration in Washington. The Obama administration and Democratic leaders in Congress have proposed to revise U.S. income taxation of both U.S. Multinationals' foreign sourced income and Foreign Multinationals' U.S. sourced income. The proposed revisions are in response to perceived inequities that benefit U.S. Multinationals' foreign activities at the cost of U.S. workers, as well as the need to raise additional revenue to pay for healthcare reform.

President Obama has released proposed revisions to the U.S. income taxation of U.S. Multinational corporations and, in support of these proposals, has offered a statistic that U.S. Multinational corporations pay on average a two percent U.S. tax on their income earned abroad. This statistic disregards the fact that U.S. Multinationals pay corporate income tax in the foreign countries where they operate, albeit often at a lower rate than U.S. corporate income taxes. President Obama's goals are to raise revenue and keep jobs in the U.S. by curbing tax planning techniques used by multinational corporations with respect to their foreign income and he believes that these tax planning techniques decrease tax revenues, while encouraging companies to hire workers overseas. His administration estimates that the proposed revisions could raise approximately \$190 billion over 10 years.

If enacted, many of the Obama Administration's proposals would become effective in 2011. He proposes to disallow U.S. Multinationals' deductions on their U.S. tax returns for expenses they incur supporting their foreign operations (such as interest expense on money borrowed to invest overseas) until they pay U.S. taxes on their foreign income. The administration claims this would raise \$60.1 billion over 10 years. Additionally, Obama has proposed to close foreign tax credit "loopholes" that allow U.S. Multinationals to artificially inflate or accelerate their foreign tax credit by claiming foreign tax credits for taxes they pay on foreign sourced income not yet subject to current U.S. tax. The administration claims this would raise \$43 billion over 10 years. Obama also proposes to eliminate the

check the box rules that allow a foreign subsidiary to be disregarded as a separate entity. This proposed change would make it harder for U.S. corporations to properly and reasonably allocate income and loss from one foreign subsidiary to another foreign subsidiary. The administration claims this would raise \$86.5 billion over 10 years.

Obama anticipates that his tax proposals, if enacted by Congress, would result in the IRS conducting additional audits of U.S. Multinationals. Therefore, he proposes additional funding to the IRS to hire 800 new employees devoted to enforcing U.S. tax law on international activities of U.S. Multinationals. The new employees would enforce not only the Obama administration's new tax proposals, but also enforce existing international tax laws.

Democratic leaders in Congress have also proposed their own revisions to U.S. income taxation of U.S. Multinationals, and they extend their revisions to U.S. income taxation of Foreign Multinationals with U.S. activities. Some of their proposals are contained in the America's Affordable Health Choices Act of 2009 ("AAHCA"). The Democratic leaders intend their revisions to U.S. income taxation of U.S. Multinationals to partially fund healthcare reform.

Applicable to U.S. Multinationals, AACHA would defer until Jan. 1, 2020 rules affecting the worldwide allocation of interest of U.S. Multinationals and their foreign subsidiaries (the "Worldwide Affiliated Group"). As the law currently exists, starting on Jan. 1, 2011, Worldwide Affiliated Groups will be able to allocate interest expense on a worldwide basis between U.S. sources and foreign sources for purposes of determining the foreign tax credit. The purpose of this allocation is to allow corporations to avoid the effect of the existing interest expense allocation rules that cause U.S. Multinationals to allocate a portion of their U.S. interest expense to foreign source income. Delaying the effective date of interest allocation rules to year 2020 is expected to raise \$26.1 billion over 10 years.

Applicable to Foreign Multinationals, AACHA would limit tax treaty benefits for U.S. withholding taxes on U.S. sourced income paid overseas to Foreign Multinationals. The U.S. has comprehensive income tax treaties with many foreign countries. These tax treaties reduce U.S.

withholding taxes on payments by U.S. persons to foreign persons. Currently, a U.S. subsidiary of a Foreign Multinational can make a deductible payment to a foreign affiliate located in a country with which the U.S. has a tax treaty, and the U.S. subsidiary can apply the lower withholding tax provided in the treaty. Congress is concerned that certain payments may be routed via tax advantageous jurisdictions in order to for the parties to inappropriately avail themselves of treaty benefits. By limiting treaty benefits in circumstances in which payments are routed via "treaty shopping" techniques, Congress intends to ensure that the appropriate withholding tax will apply. This proposal is effective on enactment and is expected to raise \$7.5 billion over 10 years.

Some observations can be made of the tax proposals. The proposals do not appear to take into account that the U.S. has higher corporate income tax rates than a majority of its trading partners, which significantly challenges U.S. Multinationals who compete with foreign competitors subject to lower tax rates. The proposed tax increases move in the opposite direction of recent actions announced in Japan and Britain, the two countries that, along with the U.S., are home to the largest number of multinational corporations. In recent weeks, Japan and Britain have announced tax benefits designed to give their multinational corporations a competitive edge over multinationals from other countries. Moreover, as a result of the additional IRS employees engaged in enforcing U.S. income taxation of U.S. Multinationals, such companies should expect the IRS to more heavily scrutinize their activities. Each of these proposals may have a significantly negative impact on the global profitability of U.S. Multinationals. While the legislative future of these proposals remains somewhat unclear, any U.S. Multinational with an existing overseas operation would be wise to pro-actively review its international tax risk profile at this time.

Final Observations

There are two primary benefits that companies can derive from efficient international tax planning. First is the ability to mitigate, or in some cases eliminate, multiple layers of taxation on one item of income. This lowers the company's global effective tax rate and directly affects the

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company's bottom line. In other words, cash that otherwise would have been lost to taxes can be used for income-producing activity. Second is treasury management. Essentially, all effective international tax planning boils down to treasury management. The goal of any cross-border activity is to move cash around the world, or around the corporate organizational structure, in the most efficient way. Effective and early tax planning can properly allow companies to manage these two primary concerns, and it can enable the company to better achieve its initial goal: to be profitable. So while the issue of international taxation can be complex and fluid, appropriate planning can result in great rewards for any company engaging in cross-border dealings. ■

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End Notes

1. This article does not discuss U.S. state and local income taxation or foreign income taxation at the local level.

2. In 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48: Accounting for Uncertain Income Taxes ("FIN 48"). FIN 48 imposes an assessment of tax liabilities on companies adhering to U.S. financial reporting standards. In each taxing jurisdiction (i.e., in the U.S. and in each foreign country where the U.S. Multinational is liable for tax), the U.S. Multinational will need to determine its uncertain tax positions. The U.S. Multinational will then need to apply a two step process to its U.S. and its foreign tax positions.

Under the first step, the company must determine whether it is more likely than not that a U.S. or foreign tax position will be sustained upon examination in the applicable jurisdiction based on the merits of the position. If the tax position meets the more likely than not recognition standard, the company applies the second step. Under the second step, the tax position is measured at the largest amount of the benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the authorities in the jurisdiction, and this is the amount of the benefit to recognize in the financial statements. The multi-step assessment is complex enough when applied to U.S. tax positions. It gets even more complex when cross border transfer pricing, income tax treaties, and the U.S. worldwide income tax system (including foreign tax credits) are thrown into the mix.

3. This common planning technique is one of many international tax items that are currently the subject of proposed tax reform legislation in Washington. Please see further below for additional discussion.

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