

Choice of Entity for Expansion of Operations into a Foreign Country

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When expanding into a foreign country, tax-savings decisions are affected by many factors, including the choice of entity. This article describes how that choice is involved in managing global tax strategies.

The U.S. has a global income tax system that applies to taxable income of U.S. businesses¹ earned in the U.S. and throughout the world. U.S. businesses with operations in a foreign country may be subject to foreign income taxes as well. Thus, U.S. businesses with foreign income are potentially subject to double taxation.²

When expanding into a foreign country, many factors affect tax-saving strategies. These include the company's goals, the nature and location of the foreign business activity, the foreign country's income tax rate, the type of entity used for foreign operations, the profitability of foreign operations and the U.S. owner's need to receive periodic transfers of funds.

This article describes how a U.S. taxpayer's goal of managing its global tax liability affects its choice of entity when expanding into a foreign country. The application of

the tax law is illustrated by considering the entity choices available to "A," a hypothetical U.S. manufacturer.³ Exhibit 1 on p. 396 contains the income statement for A, based on the following facts.

Example 1: A currently manufactures and sells 100,000 units per year, with a selling price of \$50 and a manufacturing cost of \$25 per unit. Administrative and selling expenses are \$15 per unit; A's Federal tax rate is 34%.⁴ There is no state income tax.⁵ A has determined that it can double its business by expanding into a foreign country. If it does so, A's per-unit production costs and other operating costs (including selling and distribution) for the additional production will be unchanged.

The motivation for expansion is to increase profits through increased sales. Additional benefits, including lower manu-

¹ In this article, "U.S. business" refers to any U.S. person with business operations. Under Sec. 7701(a), a "person" includes an individual, partnership or corporation. A "U.S." person includes a U.S. citizen or resident, a domestic partnership, a domestic corporation and other entities. A domestic corporation or partnership is one created or organized in the U.S. or under the law of the U.S. or of any state. Other corporations and partnerships are foreign corporations or partnerships.

² Both U.S. and foreign tax law are discussed in this article.

³ The AICPA Tax Division publishes a set of checklists

entitled "Practice Guide to International Tax Planning" each year for its members, which can be helpful for international tax planning or compliance, available at <http://tax.aicpa.org/Resources/Tax+Practice+Guides+and+Checklists/>.

⁴ Larger companies are subject to a 35% marginal income tax rate under Sec. 11(b). The small company in this example is subject to a 34% marginal rate, which is used throughout this article.

⁵ State income tax issues are not covered in this article.

facturing costs from offshore manufacturing, lower shipping costs and lower local income taxes on foreign profits, may also lead to international expansion.

No Taxable Foreign Presence

In the simplest case, a U.S. company may choose to sell its product in a foreign country, while minimizing its exposure to that nation's income taxes. One purpose of U.S. tax treaties with many foreign countries is to clarify which country may impose a tax on business activities, thus reducing the amount of double taxation. Under the U.S. Model Income Tax Convention,⁶ a U.S. company will be subject to income tax by a foreign country only if it has earnings from a permanent establishment (PE) in the foreign country. Article 5(6), Permanent Establishment, of the model convention provides:

An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as independent agents.

The term PE does not include the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise.

A U.S. company may delegate foreign sales activity to an independent sales agent in the foreign country and limit its distribution activities to storing, displaying and shipping the products. In this situation, the U.S. company generally will not have a PE creating a taxable presence

in the foreign country as a result of its sales activities, assuming the company is operating in a country with which the U.S. has an income tax treaty in force.⁷

Example 2: A, from Example 1, expands its manufacturing capacity in the U.S. and sells its product in the foreign country. A minimizes its business activities in the foreign country and is not deemed to have a PE there. Financially, this expansion will result in A doubling its taxable income (from \$1 million to \$2 million) and its U.S. income tax (from \$340,000 to \$680,000). A would not incur income taxes in the foreign country.

Of course, foreign laws may vary, and A should carefully consider the foreign country's laws regarding a PE. A complete analysis in this situation would consider other taxes, fees and charges, including the VAT (none of which are covered in this article).

Choice of Entity for Foreign Expansion

In some cases, a U.S. business needs a substantial presence in a foreign country, even if that means operating through a PE that is subject to foreign income taxes.

One choice is to organize a wholly owned branch office⁸ in the foreign country. A foreign branch is not a separate entity, but instead provides flow-through of income and losses for U.S. tax purposes. A "branch" also means a foreign entity with a single owner⁹ that the company has elected under the check-the-box regulations (a CTB election) to be treated as a disregarded entity (DE), by filing Form 8832, Choice of Entity Classification.¹⁰

tion or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." (Emphasis added.) This defines a branch as not being a separate entity but, rather, an extension of its owner. The term is often used in a manner that suggests a broader definition.

⁹ A "checkable" foreign entity is a foreign entity for which the U.S. owner makes an election as to entity status under the Sec. 7701 regulations.

¹⁰ See Regs. Sec. 301.7701-2.

⁶ United States Model Income Tax Convention of November 15, 2006, Article 7, Business Profits.

⁷ The U.S. has comprehensive treaties with more than 50 countries. If there is no treaty, maintenance of inventory would likely cause a taxable presence and the company might incur local income tax and be required to file an income tax return. The company may also be liable for collection and remittance of value-added tax (VAT), if applicable. Other taxes could also apply (property tax, etc.).

⁸ Regs. Sec. 301.7701-2(a) provides that "A business entity with only one owner is classified as a corpora-

EXECUTIVE SUMMARY

■ When flowthrough treatment is desired, a U.S. business may expand into a foreign country with a branch office or plant.

■ A foreign partnership is advantageous when foreign operations are expected to generate flowthrough losses to a U.S. partner, and foreign taxes are high.

■ A foreign corporate entity is preferred if the foreign tax rate is low or nonexistent, and the objective is to defer payment of U.S. taxes on foreign earnings.



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Exhibit 1: A's income statement (before expansion)

Revenue and costs	Per unit	Total
Sales in units = 100,000		
Revenue	\$50.00	\$5,000,000
Cost of goods manufactured	(25.00)	(2,500,000)
Gross margin	\$25.00	\$2,500,000
Administrative, selling and shipping costs	(15.00)	(1,500,000)
Net income before taxes	\$10.00	\$1,000,000
Federal income tax (34%)	(3.40)	(340,000)
Net income	\$6.60	\$660,000

A second option is a partnership, which may be organized in the U.S. (a domestic partnership) or in a foreign country (a foreign partnership) and may include foreign partners. A partnership is a flowthrough entity. It may provide needed capital for expansion. In addition, a foreign partner may provide expertise on the foreign business climate and operating practices. This option also includes a foreign entity with two or more owners, for which an election on Form 8832 is made.

A third option is to organize or purchase a foreign corporation. This may permit reporting foreign earnings on the U.S. income tax return to be deferred, because it is not a flowthrough entity.

Foreign Branch or Other Wholly Owned Flowthrough Entity

When a U.S. business expands into a foreign country with a branch office or plant, in some cases it is necessary to organize the wholly owned local entity under local law. Under the CTB regulations (Regs. Sec. 301.7701-2 and -3), a taxpayer generally can select the U.S. tax classification of a foreign entity. However, there is no choice if the foreign entity is a *per se* corporation,¹¹ because it will be treated as a C corporation for U.S. income tax purposes.

A foreign entity may be disregarded (i.e., treated like a branch) for U.S. tax purposes as a result of an election under the CTB regulations, while being treated as a corporation under foreign tax law (a "hybrid" entity). Operating results of a branch or DE are reported on the owner's income tax return. Foreign earnings may be subject to both U.S. and foreign income tax.

Example 3: *A*, from Example 1, organizes *F*, which is a branch or other flowthrough entity operating in a foreign country with a 34% income tax rate. *F* manufactures 100,000 units at a cost of \$25 per unit and sells them for \$50 per unit. *F* has net income before taxes in the foreign country of \$10 per unit. *F* will have taxable income of \$1 million and will owe \$340,000 in foreign income taxes, leaving after-tax income of \$660,000. *A* will have global taxable income of \$2 million and total U.S. income tax of \$680,000 (before credits), because its taxable income will include U.S. operations and the flowthrough of earnings from foreign manufacturing and sales operations; see Exhibits 2 and 3 on p. 397.

FTC

The double taxation effect is reduced by Sec. 901, which allows a foreign tax credit (FTC) against U.S. income tax liability for taxes paid to a foreign country. In general, the amount saved via the

FTC equals the tax paid to the foreign country, unless the foreign tax rate is higher than the U.S. tax rate. Sec. 904(a) limits the FTC based on the following formula:¹²

$$\text{U.S. tax before FTC} \times \frac{\text{Foreign source taxable income}}{\text{Global taxable income}} = \text{FTC limit}$$

A U.S. company's global tax liability on income earned in the foreign country generally will be the greater of the (1) U.S. tax on that income (before credits) or (2) foreign tax on that income. When the foreign income tax is greater than the FTC allowed, the excess FTC may be carried back one year and forward to future years (up to 10 years) under Sec. 904(c).

When analyzing the effect of foreign income taxes, current foreign income taxes, foreign withholding taxes on dividend payments and any foreign branch profits tax must be considered. The withholding tax is an additional layer of tax levied on the earnings distribution. The foreign branch tax is an equivalent tax levied on noncorporate entities. Even though a DE is treated as a branch under U.S. tax law, foreign withholding taxes apply to payments received from the entity, because it is a corporation under foreign law. A branch would be subject to the branch profits tax (if any).

When the foreign tax rate is less than or equal to the U.S. tax rate, the global tax liability will tend to be the same, regardless of the foreign tax rate, after considering the effect of the FTC on U.S. taxes. However, when the foreign tax rate is greater than the U.S. rate, the global tax liability will be greater due to excess FTCs (i.e., unused credits).

Example 4: *F* from Example 3, will pay \$340,000 income tax to the foreign country. *A*'s U.S. income tax before credits will be \$680,000, and its global income tax liability will be \$1.02 million before the FTC; see Exhibit 3. *A* will take a \$340,000 FTC, leaving net U.S. income taxes of \$340,000 after

¹¹ The term "per se corporation" refers to entities listed in Regs. Sec. 301.7701-2 that are treated as corporations under the income tax law and are not allowed to elect another status under the CTB provisions.

¹² The FTC is computed based on the separation of income into baskets, a process

not covered in this article. Starting in 2007, Section 404 of the American Jobs Creation Act of 2004 provides only two baskets: passive category income and general category income.

the credit. The global tax burden is \$680,000. Using the FTC limit formula above, the credit limit is computed as follows:

$$\$680,000 \times \frac{\$1,000,000}{\$2,000,000} = \$340,000 \text{ FTC limit}$$

If, instead, the foreign tax rate were only 30%, the foreign income tax would be reduced to \$300,000, and U.S. tax after credits would be \$380,000. The global income tax burden (\$680,000) would be unchanged. If the foreign country's tax rate were 50%, *F* would pay foreign income tax of \$500,000; however, the FTC would be limited to \$340,000. As a result, the global tax liability would increase to \$840,000 (\$340,000 U.S. tax + \$500,000 foreign tax). *A* would have an excess FTC.

Source of Income

Sec. 862(a) classifies gross income from inventory purchased in the U.S. and sold abroad as foreign-source gross income, but income from inventory produced in the U.S. and sold abroad (or vice versa) must be apportioned under Sec. 863(b)(2). Regs. Sec. 1.863-3(b) provides three methods for apportioning gross income from production and sales when inventory is produced (1) in the U.S. and sold abroad or (2) abroad and sold in the U.S. One method is the 50-50 method, under which 50% of the gross income is apportioned to the manufacturing activity and 50% to the sales activity.¹³

After apportioning gross income between U.S. source and foreign source, expenses are allocated to the different categories of income. Allocations of expenses (including interest expense) can affect the amount of taxable income classified as foreign-source taxable income, and can have a severe negative effect on the FTC.

When a company has excess FTCs, it should consider strategies to increase the

Exhibit 2: F's operations

Description	Amount
F's sales (100,000 units at \$50 each)	\$5,000,000
Cost of sales (100,000 units at \$25 per unit)	(2,500,000)
Gross profit	\$2,500,000
Administrative, selling and shipping expense	(1,500,000)
Taxable income	\$1,000,000
Foreign income tax (34% rate)	(340,000)
F's after-tax net income	\$660,000

Exhibit 3: A's global tax income liability

Description	Amount
Taxable income from U.S. operations	\$1,000,000
Taxable income from foreign operations (F)	1,000,000
Global taxable income	\$2,000,000
U.S. tax (based on global taxable income at 34% rate)	\$680,000
Add: foreign income tax paid by F	340,000
Global income tax before FTC	\$1,020,000

numerator in the fraction above, to increase the FTC currently allowed. This may be done, for example, by causing more of its inventory sales to be classified as foreign-source income through passage of title outside the U.S.,¹⁴ allocating more corporate expenses to U.S. operations and managing transfer prices for goods or services provided to (or by) the foreign entity.

Flowthrough of Losses

A loss of a foreign branch or other foreign flowthrough entity may be deducted currently on a U.S. taxpayer's income tax return. However, under Sec. 367(a)(3)(C), a foreign branch loss is recaptured when the branch is transferred to a foreign corporation. Also, under Regs. Sec. 1.1503-2(g)(2), a foreign branch loss deducted on a U.S. return may be recaptured later, in the

case of certain triggering events (such as the use of that loss for the benefit of another business).

Foreign Partnership Operations

As an alternative, a U.S. business may expand its operations by organizing a partnership or joining an existing partnership.¹⁵ Sec. 701 provides that a partnership is a flowthrough entity. Partners are liable for income tax only in their separate or individual capacities. They report their distributive shares of the partnership's income, gain, loss, deduction and credit as determined under Sec. 704.

A foreign partnership does not provide deferral of U.S. tax on foreign earnings. It does provide an advantage when foreign operations are expected to generate losses: it allows the flowthrough of

¹³ When production or sales occur in more than one country, additional allocations are required, under Regs. Sec. 1.863-3(c).

¹⁴ In *Liggett Group, Inc.*, TC Memo 1990-18, Paddington, a Delaware corporation, was the exclusive distributor in the U.S. of J&B Rare Scotch Whiskey, imported from Scotland. Paddington received purchase orders from its customers in the U.S. and forwarded them to J&B, which shipped the merchandise to Paddington's customers, F.O.B. U.K. Paddington's customers were responsible for shipping costs.

The Tax Court held that these sales were foreign-source sales that increased foreign-source income in the numerator of the limiting fraction, thus increasing the limit on Paddington's FTCs.

¹⁵ A partnership must have two or more partners, under Regs. Sec. 1.708-1(b). It is a flexible entity, in that it may have partners that are individuals, trusts, estates, corporations, associations or other partnerships.

Exhibit 4: Double taxation of foreign subsidiary earnings

	Part 1	Part 2	Part 3
Foreign subsidiary's income	\$1,000	\$1,000	\$1,000
Foreign corporate tax rate (30%)	(300)	(300)	
Foreign corporate tax holiday rate (10%)			(100)
Net profit available for distribution	\$700	\$700	\$900
U.S. income tax on dividend (15%)	(105)		(135)
U.S. income tax on income flowthrough (35%)		(350)	
FTC		300	
Net cash after foreign and U.S. tax	\$595	\$650	\$765
Effective tax rate	40.50%	35%	23.5%

In all cases, the U.S. owner is an S corporation or a partnership that does not have a C corporation as a partner. There is no foreign withholding tax or foreign branch profits tax. The dividend qualifies for the 15% rate. The top U.S. individual income tax rate is 35%.

Part 1. The dividend income qualifies for the 15% U.S. tax rate. There is no indirect FTC, because only C corporations may claim an indirect FTC for taxes paid by another corporation.

Part 2. The foreign entity is treated as a passthrough entity, so the U.S. owner does not use the 15% rate, but claims the direct FTC.

Part 3. The foreign country provides a low (holiday) income tax rate.

losses to the U.S. owner, which is a partner.¹⁶ However, a foreign partnership may be less desirable than a foreign corporation (described below) when foreign income taxes are low and the U.S. owner is a partnership, an S corporation or an individual. In that case, the foreign corporate entity offers the advantage of the special maximum tax rate of 15% under Sec. 1(h), applicable to qualified dividends received by an individual from a foreign corporation.

Under U.S. tax law, a foreign partnership is one organized in a country other than the U.S. A foreign partnership is subject to both U.S. and foreign tax law.¹⁷ For example, even though Sec. 731 generally provides that a partner does not recognize income or gain on receipt of a distribution from a partnership, the foreign country may impose a foreign withholding tax on that distribution.

Example 5: *F* is a partnership organized in a foreign country that has a 34% income tax rate. *A* owns a 50% capital interest in *F*, which

manufactures 100,000 units at a cost of \$25 per unit and sells them for \$50 per unit. *F* has selling and administrative expenses of \$15 per unit and net income before taxes in the foreign country of \$10 per unit. *F* will have taxable income of \$1 million. *A* will report its share of earnings, which is \$500,000, assuming the partnership agreement provides that *A* is to be allocated 50% of the profits.¹⁸

A will be allowed an FTC for its share of the foreign income taxes, if *F* (rather than its partners) is subject to income taxes in the foreign country, or if *A* otherwise pays a foreign income tax on its profit allocation.

The foreign partnership agreement and partnership operations should take into account both U.S. and foreign law. Special care should also be given to financing, operating, distribution and governance issues.

Example 6: *A* purchases a 50% interest in a partnership for \$2 million, with a book value of only \$1.6 million. The purchase price is

\$400,000 above book value because of appreciation in intangible assets.

Sec. 704 allows *A* to report its share of partnership income, taking into account increased amortization applicable to the \$400,000 excess payment. This benefit is obtainable only if an election is made under Sec. 754 (even when investing in a partnership organized in a foreign country in which local tax law provides this benefit automatically, without an election¹⁹).

A U.S. partner is allowed a credit for foreign income taxes allocated to it in accordance with its partnership interest, under Sec. 704(b). A domestic partnership is governed by U.S. tax law. Sec. 1446 requires a U.S. or foreign partnership to withhold tax when it has income effectively connected with a U.S. business and some of that income is allocated to a foreign partner.

Foreign Corporate Operations

A foreign corporate entity is preferred to a flowthrough entity when the objective is to defer payment of U.S. tax on foreign earnings. Foreign subsidiary earnings generally are not subject to U.S. income taxes until they are distributed as dividends. This approach is useful when a foreign country has either no income tax or a low rate, because U.S. income tax is avoided and the foreign income tax may be nonexistent or insignificant.

Example 7: *A* organizes *S* as a foreign corporation that reinvests all foreign earnings in its foreign operations. *S* has \$1 million taxable income that will not currently be subject to U.S. income taxes. *S*'s foreign income tax will be \$100,000, under the foreign country's 10% income tax rate.

A will have \$1 million global taxable income (from U.S. operations) and \$340,000 total U.S. income tax. This results in a current global tax liability of \$440,000, compared with \$680,000 in

¹⁶ This also applies to a foreign branch.

¹⁷ Such foreign businesses are often in the form of joint ventures. The foreign country may require a certain level of participation by the foreign partner, etc.

¹⁸ Regs. Sec. 1.704-1 provides some flexibility in sharing of profits and losses from a partnership.

¹⁹ See *Atlantic Veneer Corp.*, 812 F.2d 158 (4th Cir. 1987).

Examples 3 and 4. It should be noted that subpart F limits deferral of income earned by a foreign subsidiary.

The FTC from a foreign corporate subsidiary is an indirect credit under Sec. 902 and is available only for a corporate parent, not for another type of entity or an individual. The indirect credit is available only when cash is repatriated to the U.S. parent in the form of a dividend. The parent looks through the foreign subsidiary to determine its share of the subsidiary's taxable income and foreign income tax.

Example 8: *A* is a C corporation and *F* is a subsidiary that operates as shown in Exhibit 2. *F* will have foreign taxable income of \$1 million and foreign after-tax income of \$660,000. If *F* then pays a \$660,000 dividend, *A* will qualify for an FTC. *A* will gross up the dividend under Sec. 78 and will recognize dividend income of \$1 million (\$660,000 dividend + \$340,000 foreign tax) from *F*. *A* will have foreign income tax expense of \$340,000, which qualifies as an FTC for *A*.

The tax cost associated with moving the foreign earnings to the U.S. will include any U.S. income tax in excess of the related FTC. The U.S. imposes a 30% withholding rate on dividends paid to foreign persons; most U.S. trading partners impose a similar tax. Treaties set a maximum tax (e.g., 5%) when the payment is to a person in a country that has a treaty with the country from which payment is made. The cost of getting foreign earnings to the U.S. includes these withholding taxes on dividends. Close attention should be paid to foreign tax law and to any treaty between the U.S. and the foreign country that may reduce or eliminate a withholding tax. Alternatively, the U.S. parent may finance the foreign venture in part with a direct loan or guaranteed bank loan. This may allow the debt to be repaid without a foreign withholding tax.

In Example 8, if *A* is an entity other than a C corporation, no FTC for the taxes paid by the foreign subsidiary is allowed. *A* may then be able to make a CTB election to treat *F* as a pass-through entity, which should eliminate the double tax issue. Any withholding is a direct tax on the U.S. owner and would qualify as a Sec. 901 credit. Thus, the credit would apply to both the income tax on current foreign earnings and the withholding tax on the distribution.

Branch vs. Dividend Income

Income from a U.S.-owned foreign branch is subject to U.S. income tax at ordinary rates (up to 35%), regardless of the U.S. owner's classification. The U.S. owner of the branch includes all of the foreign income tax in its FTC computations. When a foreign subsidiary is used, only a corporate parent can take the indirect FTC under Sec. 904 for taxes paid by the subsidiary.

Individuals receiving dividends from a foreign corporation may be subject to the special 15% maximum tax rate under Sec. 1(h).²⁰ This lower U.S. tax rate on dividend income may cause a U.S. owner that is a flowthrough entity (e.g., an S corporation or a partnership) or an individual to choose a foreign corporate operation over a foreign branch when foreign income tax rates are low, despite the inability to take an indirect FTC. This is illustrated in Exhibit 4 on p. 398.

Transfer Pricing

If the foreign income tax rate is lower than the U.S. tax rate, a U.S. parent should carefully consider the prices charged for goods or services it provides to its foreign corporate subsidiary. A reduction in these prices will result in an increase in foreign income and a reduction in U.S. income. The same results are obtained when goods are imported from the foreign subsidiary, and the parent determines that it should pay higher prices for those goods.

When a wholly owned flowthrough entity is used, transfer prices may not affect U.S. taxable income, because such income includes profits from U.S. and foreign operations. However, charging higher transfer prices to the foreign entity may reduce the foreign income taxes paid.

The U.S. and many other countries regulate transfer prices, to reduce the ability to arbitrarily shift income.²¹ In general, under U.S. and international standards, a transfer price must be at arm's length. Taxpayers must develop and keep documentation supporting the reasonableness of their transfer-pricing methods. Sec. 482 gives Treasury the authority to reallocate income, deductions and credits among related entities to ensure that an entity reports its share of profit. Sec. 6662(a) and (h) impose an accuracy-related penalty of 20% or 40% of the tax underpayment caused by inaccurate intercompany-pricing methods.

Other Considerations

Foreign Tax Holiday

A foreign country may give a tax holiday for a start-up period, such as five years. A tax holiday is of no benefit if the foreign subsidiary realizes start-up losses throughout the tax holiday period. The U.S. company and the foreign subsidiary may be able to structure their business relationship to allow the foreign subsidiary a significant portion of the profits during the holiday period. A transfer-pricing analysis will be needed to determine the profit allocation. In addition, when the tax holiday expires, the companies may need to examine their business relationship. This strategy is of no value in reducing U.S. income tax if the foreign business is a flowthrough entity for U.S. tax purposes.

Subpart F Issues

Subpart F (Secs. 951-965) places some limits on a U.S. parent's ability to defer payment of U.S. income tax by moving income to subsidiaries organized in

²⁰ This rate is scheduled to expire after 2010; see Section 301 of the American Jobs and Growth Relief Reconciliation Act of 2003, as amended by Section 102 of the Tax Increase Prevention and Reconciliation Act of 2005.

²¹ The U.S. works in partnership with other countries through the Organisation for Economic Co-operation and Development to develop uniform transfer-pricing practices to minimize double taxation.

Exhibit 5: Key tax-saving considerations

1. Keep it simple.

A company may expand manufacturing operations in the U.S. and sell its additional production in a foreign country, while minimizing its business activities there. This may shield the company from foreign income tax and minimize foreign tax compliance costs.

2. Start-up losses.

A start-up loss of a foreign branch or other foreign flowthrough entity may be deducted currently on the U.S. taxpayer's income tax return. However, such loss may be recaptured under Sec. 367(a)(3)(C) or Regs. Sec. 1.1503-2(g)(2).

3. Minimize double taxation.

If foreign income tax rates are equal (or approximately equal) to U.S. rates, a primary goal is the reduction of double taxation. The FTC allowed on a U.S. income tax return tends to reduce the effect of double taxation. If a foreign income tax is fully creditable against the U.S. tax, nothing is gained through further reduction in the foreign income tax, because that simply reduces the FTC and increases the U.S. tax after the credit. A C corporation (but not an S corporation, a partnership, an LLC or an individual) may claim an indirect FTC under Sec. 902.

4. Defer income recognition on the U.S. return.

If the foreign country has no income tax, or very low rates, the goal is for the U.S. parent to defer income recognition and related tax payments, assuming it does not need to receive current distributions. This can be accomplished by using a foreign C corporation and having foreign earnings reinvested, rather than being distributed as dividends. The U.S. parent generally will not report foreign earnings until they are transferred to the U.S., except as required under subpart F, which is summarized in this article.

A U.S. company that is a partnership (having no partner that is a C corporation) or an S corporation may prefer to organize a foreign passthrough entity to reduce double taxation via the FTC. However, as Part 3 of Exhibit 4 illustrates, the 15% dividend rate may cause a C corporation to be the better choice when the foreign tax rate is low.

5. Minimize exposure to high foreign taxes.

When foreign income tax rates are higher than in the U.S., the FTC only partially eliminates double taxation. The goal is to minimize the income subject to tax in the foreign country. Tax planning may affect the nature of the activity in each country, the financial structure and transfer pricing. Using a flowthrough entity (rather than a corporate subsidiary) does not help, because a flowthrough entity places foreign income on a U.S. return without affecting the foreign income tax return.

6. Taxes on fund transfer to the U.S.

Consider current foreign income taxes and any foreign withholding taxes that may be imposed later when foreign earnings are paid to the U.S. owner. The presence of a foreign withholding tax on fund transfers may affect the foreign entity's capital structure and financing sources.

tax-haven countries.²² If the product is produced and sold outside the tax-haven country, the U.S. parent must currently recognize its share of the tax-haven subsidiary's income under Sec. 951(a). The same approach applies to certain passive income earned by the foreign subsidiary.

Example 9: A sets up F as an offshore subsidiary in a foreign jurisdiction that has no income tax. A sells its product to F at cost, resulting in no profit for A. F sells the product at a profit to unrelated customers in another foreign country.

Through innovative intercompany pricing, profit can be shifted from A to F and F will pay no income tax on that

portion of global profits. This involves moving profits from a taxing environment to a tax-free environment. Subpart F requires F's profit to be included in A's income, thus reducing the opportunity for such tax avoidances.²³

Despite the subpart F limits illustrated above and various transfer-pricing rules, many U.S. corporations find it profitable to establish tax-haven subsidiaries. In a 2004 study, the Government Accountability Office (GAO) found that 59 of the 100 largest publicly traded Federal contractors from fiscal-year 2001 reported having at least one subsidiary in a tax-haven country.²⁴ U.S. corporations use exceptions to subpart F for their benefit, as well as CTB planning. They also may

take advantage of favorable provisions in treaties between the tax haven and the other foreign country.

Conclusion

Global tax management requires careful consideration of concepts such as income deferral, reduction in double taxation with the FTC and managing income sources. As seen in Exhibit 5 above, tax planning takes into account such factors as projected profitability of foreign operations, current foreign income tax rates, taxes and other limits on the distribution of foreign earnings, and alternative types of entities that may be used in foreign operations. **TTA**

²² A "tax haven" is a country that imposes no income tax, or has a very low income tax rate.

²³ Subpart F covers gross profits from inventory sales and certain other types of income, including passive income. However, deferral is available for profits from sales of inventory that is produced (or sold for use) in the country in which the con-

trolled foreign corporation is organized, and certain types of active business income.

²⁴ "International Taxation: Information on Federal Contractors with Offshore Subsidiaries" (GAO-04-293, February 2004), available at www.gao.gov/htext/d04293.html.