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Location: A Taxing Choice For New Businesses

Law360, New York (June 25, 2009) -- Given the raft of issues involved in launching a new business in the U.S., it should come as no surprise that the question of where the new legal entity should be formed is often given short shrift, when it is considered at all.

This is unfortunate, because investing time and effort upfront in considering the tax implications of the location decision can pay significant dividends in terms of tax savings down the road.

This is especially the case for new companies that see themselves as one day doing business abroad. In fact, in light of new and potential tax changes under the Obama administration, if there is any possibility that a new entity might do business overseas, then its founders would do well to consider forming the corporation, from inception, outside the United States.

Of course, as with any complex decision, there can be downsides as well. In the following, we briefly examine some of the pros and cons, from a tax perspective, of forming a new corporation, ab initio, outside the U.S.

Avoiding Tax Deferral Limits and Foreign Intangibles Transfer Fees

Recent months have seen a large number of new proposed and/or temporary regulations, encompassing hundreds of pages of fine print, which could impact the question of whether to form a new company in or outside the U.S. Among these are the Obama Budget Proposal to "Reform Deferral" and the issuance of IRS Letter Ruling (PLR) 200907024 (Nov. 10, 2008).

It remains unclear just how the Obama administration plans to reform the current tax deferral on unrepatriated foreign earnings.

However, given the administration's claim that its Budget Proposal will increase tax receipts by more than \$200 billion between 2011 and 2019, it seems safe to assume

that the current tax deferral on foreign earnings of U.S.-based corporations will be greatly limited in the future. Forming the company abroad from inception would allow entrepreneurs to sidestep this concern.

The impact of PLR 200907024 can be made more precise. In it, the IRS limited the goodwill and going concern exceptions of the tax code that deal with the transfer overseas of intangibles.

The IRS has indicated that the method of operation, related contracts, and franchises are not elements of goodwill or going concern value, but are intangibles.

Therefore, the transfer of these intangibles to a related foreign entity is subject to the “commensurate with income requirements” of intangible transfer rules.

This ruling might severely limit the future transfers of operating businesses in the U.S. to related foreign corporations, because it entails that taxable intangible transfers encompass most intangibles.

Unfortunately, this means that only the residual value of a business operation – after all tangible and intangible assets have been identified and valued – would constitute nontaxable transfers of goodwill or going concern value.

Based on this ruling, a related foreign transferee entity would be required to pay the U.S. transferor a license fee commensurate with the annual future income earned through the use of the transferred intangibles.

An entrepreneur in the U.S. can avoid such licensing fees by forming his or her company abroad from the outset, because then the intangible would be created in a foreign corporation, rather than transferred there. Transfers of intangibles between foreign corporations or to a U.S. corporation would not create a U.S. tax liability.

While a license fee possibly based on the commensurate-with-income standard may be charged to a U.S. transferee, tax planning can be used to avoid or reduce the U.S. 30 percent royalty withholding tax.

Other Considerations

Forming a new corporation abroad of course entails that all of its subsequent operations in the U.S. will be conducted through a foreign company.

Before doing this, it is important to determine the possible downsides of such a decision, and further decide how to conduct the U.S. business. There are three options:

— Forming a U.S. branch of a foreign corporation.

— Forming a foreign corporation with a U.S. subsidiary.

— Forming a foreign partnership comprising individual U.S. partners.

Branch of a Foreign Corporation

The income that a foreign corporation generates in the U.S. through the operations of a U.S. branch is subject to U.S. income tax on a net income basis in the same manner, and at the same tax rates, as income earned by a domestic corporation.

In addition, the net earnings of the U.S. branch are subject to the Branch Profits Tax, a levy designed to be similar to the U.S. withholding tax on dividends. If the branch has no net after tax current or accumulated income, the branch profits tax would be nil.

Unfortunately, if the foreign corporation is owned by U.S. individuals, then neither the U.S. tax on the U.S. branch's earnings nor the branch profits tax are allowed as a credit in computing the U.S. individual shareholders U.S. tax liability.

In effect, taxes paid by the foreign corporation merely reduce the foreign corporation's earnings and profits.

However, if the foreign corporation is 10 percent or more owned by a U.S. corporation, then dividends paid by the foreign corporation might be eligible, under Section 245, for a dividend received deduction.

Foreign Corporation with a U.S. Subsidiary

A U.S. subsidiary of a foreign corporation is subject to U.S. tax in the same manner as a domestically owned U.S. "C" corporation.

Therefore income earned by the U.S. subsidiary will be subject to regular U.S. corporate tax and dividends paid to the foreign parent corporation will be subject to U.S. dividend withholding tax.

The basic rate of the dividend withholding tax is 30 percent, though this tax rate is reduced, and is in some cases to nil, under U.S. tax treaties.

Because of the imposition of the dividend withholding tax, it can be beneficial to form the foreign corporation in a jurisdiction having a tax treaty with the United States.

Under tax treaties entered into by the United States with foreign jurisdictions, the rate of U.S. withholding tax is also reduced with respect of interest income, and royalty income.

Thus arm's length royalties charged to a U.S. subsidiary by its foreign parent company, may be paid, under tax treaties, to the foreign parent free of U.S. withholding tax. Such royalty payments are also allowed as a deduction in computing the U.S. subsidiary's net U.S. taxable income.

When considering this arrangement, U.S. entrepreneurs should make certain that the foreign corporation will be entitled to the benefits of a tax treaty and that rules designed to prevent treaty shopping will not apply. Treaty jurisdictions which might be considered are Ireland and Switzerland.

Foreign Partnership Comprising Individual U.S. Partners

Finally, one can opt to operate in the United States through a foreign partnership, or foreign corporation electing to be treated as a partnership, having a U.S. branch.

The advantage of this structure is that it provides for a single layer of U.S. income tax, since the U.S. branch income would be subjected to U.S. tax at the U.S. partner level.

The foreign partnership would file a U.S. partnership tax return and each U.S. partner would pay tax on his share of partnership income.

One downside, however, is that it is questionable whether intangibles created by the partnership or the U.S. branch would be deemed owned by a foreign entity, rather than the U.S. partners involved.

The Internal Revenue Service might contend that the partnership is not a separate entity, but an aggregation of assets owned by the partners. Under this analysis, intangibles created by the partnership or branch would be considered owned by the U.S. partners.

Since, as we noted earlier, it is important for created intangibles to be owned by a foreign entity, if initial operations are conducted through a foreign partnership, then the partnership should form a foreign corporation that would pay for the creation of intangibles used in the business.

The fees received by the foreign intangible holding corporation, as royalty income or income for the use of an intangible, would be subject to U.S. withholding tax of 30 percent.

This withholding can be reduced to nil, however, if the royalty recipient, the foreign corporation, is a tax resident in a country having a tax treaty with the United States providing for a nil rate of withholding tax on royalty payments.

Time Spent Today Can Reduce Tomorrow's Tax Liability

In short, the question of where to form a new business entity should not be taken lightly. Entrepreneurs who are considering overseas operations will, in particular, benefit from considering the tax implications of where they form their business, and how, if it is formed abroad, the U.S. operations of the business should be structured.

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