

AN INTERNATIONAL TAX REVIEW: THE U.S.-BASED MULTINATIONAL'S ANNUAL CHECKUP

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FORMER IRS INTERNATIONAL ATTORNEY ROBERT MISEY OUTLINES ISSUES AN INTERNATIONAL TAX PROFESSIONAL SHOULD REVIEW ANNUALLY.

Due to the increased globalization of trade, more U.S. companies conduct foreign operations. At the same time, the IRS continues to place a greater percentage of its resources with the enforcement of the international tax provisions in the Internal Revenue Code ("the Code"). The IRS's increased scrutiny has induced many tax professionals to conduct an annual review of their companies' international tax issues. The purpose of this article is to provide a guide to the issues the tax professional should review annually. All of the examples include USCO, a U.S. C corporation that manufactures widgets.

Subpart F and Passive Foreign Investment Companies

A fundamental rule is that USCO will not have to report the income earned by foreign subsidiaries and may defer paying U.S. tax until repatriating cash¹ as a dividend. However, the tax professional

should review whether the subpart F or the passive foreign investment company (PFIC) anti-deferral regimes may apply, resulting in USCO reporting the income of a foreign subsidiary.

Subpart F income often arises when there is a related party transaction with a foreign subsidiary and that foreign subsidiary earns income outside the foreign subsidiary's country of incorporation.² The most common type of subpart F income is foreign base company sales income. For example, suppose USCO has a Hong Kong subsidiary that purchases widgets from USCO and sells them in Singapore. Unless an exception applies, the income from the Singapore sales is foreign base company sales income,³ which is a component of subpart F income, and must be reported on USCO's

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U.S. return. Other common components of subpart F income include foreign personal holding company income⁴ (passive income earned by the Hong Kong subsidiary) and foreign base company services income⁵ (income earned by the Hong Kong subsidiary for services performed outside of Hong Kong). Tax professionals should confirm that foreign subsidiaries do not conduct operations outside their country of incorporation.

The PFIC regime applies when a foreign subsidiary has either over 75 percent of its income as passive income or over 50 percent of its assets producing passive income.⁶ Foreign subsidiaries often become PFICs when they are dormant and still have cash that has not been repatriated to USCO. For example, suppose USCO has a Canadian subsidiary that has not operated for several years. All of the Canadian subsidiary's assets constitute bank deposits earning interest. Because 100 percent of the Canadian subsidiary's income is passive, the Canadian subsidiary is a PFIC. Tax professionals should confirm that dormant subsidiaries do not have significant amounts of passive income or passive income producing assets.

Foreign Tax Credits

Double taxation occurs when both a foreign country and the U.S. claim jurisdiction to tax a particular type of income. The primary method by which the U.S. alleviates double taxation is the foreign tax credit.

As its foreign subsidiaries become more profitable, USCO may begin repatriating cash to the U.S. in the form of dividends. At that time, USCO should be able to credit taxes paid by the foreign subsidiaries to avoid double taxation.⁷ This foreign tax credit is based on a pool of ac-

cumulated earnings and profits and accumulated foreign income taxes paid. The foreign tax credit calculation is subject to complex limitations on income earned in nine different baskets.⁸

Although the IRS's international examiners may overlook the allocation of income and taxes to the nine different baskets, they understand the substantiation of foreign income taxes paid regulations. The tax professional should ensure that each foreign subsidiary is maintaining proper records of foreign income taxes paid or accrued.

The foreign tax credit substantiation, as with the substantiation for all other items on a return, must be available for the IRS during examination. The primary substantiation for foreign income taxes paid by a cash basis taxpayer is a receipt for payment. The primary substantiation for foreign income taxes paid by an accrual basis taxpayer is the foreign tax return.⁹

If the IRS, in its discretion, is satisfied that USCO cannot furnish primary substantiation, USCO may furnish secondary substantiation.¹⁰ In lieu of a receipt for payment for foreign income taxes paid, a cash basis taxpayer must be able to provide a photocopy of the check, draft or other medium of payment showing the amount and date, with evidence establishing that the tax was paid for the foreign subsidiary's account. In lieu of a foreign return for foreign income taxes paid, an accrual basis taxpayer must be able to provide a certified statement of the accrued amount, with excerpts from its books showing the computation of the accrued amount.

Because the foreign tax credit is based on accumulated pools, the tax professional should ensure that USCO's foreign subsidiaries are and have been properly substanti-

ating their foreign income taxes paid. For example, this issue arises when the IRS audits USCO in the year 2002 for USCO's 2000 return, on which USCO received a dividend from a foreign subsidiary that resulted in indirect foreign tax credits for foreign income taxes paid in 1989. If the foreign subsidiary did not maintain the proper substantiation, the IRS will disallow the foreign tax credits on audit. If the primary substantiation does not exist, the tax professional should immediately begin accumulating the required secondary substantiation.

Sourcing Issues

The amount of income the Code treats as foreign source income limits USCO's ability to take foreign tax credits. The greater the amount of foreign source income, the greater the amount of the foreign tax credit limitation. Mathematically, this limitation is expressed as follows:

$$\frac{\text{Foreign Source Income}}{\text{Worldwide Income}} \times \text{Pre-Credit Tax}$$

Because of this limitation, the tax professional should analyze the accounting of foreign source income on all sales—to both related and unrelated parties.

Different sourcing rules apply to sales of purchased inventory than to sales of manufactured inventory. Sales of purchased inventory are sourced by the passage of title.¹¹ If title passes in the U.S., the income from the sale is U.S. source. If title passes abroad, the income from the sale is foreign source income. The sale of manufactured inventory is usually sourced partially to U.S. source income and partially to foreign source income under a "50/50" method.¹²

The tax professional should verify that the controller is adhering to the proper sourcing rules to:

- find additional foreign source income to increase the foreign tax credit limitation and
- ensure support for the foreign tax credit limitation if audited.

Transfer Pricing

The transfer price is the price paid in intercompany transactions, which must be at arm's length.¹³ The arm's-length pricing requirement applies to intercompany transactions for the sale of goods, the royalty for the use of intangible property, the interest rate for loans and the charge for services. Although many tax professionals associate transfer pricing with the sale of goods, the simplest scenarios for U.S. companies expanding abroad can result in numerous transfer pricing issues.

Assume, for example, that USCO manufactures and sells widgets in the United States. Due to increased widget orders from Canadian customers, USCO decides to form a Canadian distribution subsidiary ("CanDist"). Although CanDist does not have any manufacturing functions, CanDist employs its own office and sales staff while using USCO's unique distribution software to ensure that there are not any distribution problems. In an effort to ensure that CanDist is financially solvent, CanDist has payment terms to USCO of nine months and, if CanDist's customers do not pay, CanDist enjoys the use of USCO's collection staff. CanDist's average collection period is two months.

This simple example results in four transfer pricing issues:

1. The sale from USCO to CanDist of widgets constitutes a sale of tangible property, which is the type of intercompany transac-

tion tax professionals traditionally contemplate when reviewing transfer pricing.¹⁴

2. CanDist's use of USCO's unique distribution software, regardless of whether the software is patented, constitutes a method, program or system and is the transfer of intangible property.¹⁵
3. USCO's trade receivable from CanDist for nine months constitutes an intercompany loan on which the arm's-length rate of interest must accrue unless an exception applies.¹⁶
4. USCO provides collection services to CanDist and should receive an arm's-length charge for those services.¹⁷

The tax professional will want to examine these types of intercompany transactions properly and prepare the documentation necessary to avoid the transfer pricing penalty.¹⁸ If the tax professional feels comfortable with USCO's transfer pricing practices, the tax professional may want to seek either an Advance Pricing Agreement or a Small Taxpayer Advance Pricing Agreement with the IRS.

Permanent Establishment Issues

The tax professional should determine whether any personnel located or any branch activities conducted in a foreign country constitute a permanent establishment that will subject USCO to tax in that foreign country.

Assume, for example, that USCO does not have a Canadian subsidiary. Instead, USCO has a salesperson in Chicago travel to Toronto for the first two weeks of every month to negotiate and enter contracts with Canadian customers. In this situation, the salesperson

could constitute a permanent establishment under the U.S.-Canadian tax treaty and subject USCO to Canadian taxation on sales to the Canadian customers.¹⁹

By determining the nature and the activities of any USCO personnel operating in a country where USCO does not have a foreign subsidiary, the tax professional should be able to determine whether USCO has any exposure to tax in that foreign country. Similarly, the tax professional should ensure that any USCO personnel working in a country in which USCO does have a foreign subsidiary are officially employed by that foreign subsidiary to prevent those personnel from inadvertently becoming a permanent establishment of USCO.

Incorporation of Foreign Branches as Foreign Subsidiaries

The tax professional should closely scrutinize the incorporation of any foreign branches as foreign subsidiaries. As previously mentioned, USCO generally will not report the income its foreign subsidiaries earn. The Code contains provisions that prevent USCO from (1) deducting losses of foreign operations and then incorporating the foreign operations when profitable and (2) deducting the costs of developing intangible property in the United States and contributing the intangible property to a foreign subsidiary for profitable use outside the U.S. taxing jurisdiction.

Suppose, for example, that USCO has operated as a branch in Mexico for the last five years. This year, USCO's management decides to incorporate the branch in Mexico, creating a Mexican corporation. To the extent that the operations of the

Mexican branch have previously resulted in losses that USCO deducted on its return, USCO may have to recapture these losses on incorporation.²⁰ Furthermore, to the extent that the Mexican branch created intangible assets, such as know-how or customer lists, now owned by the Mexican corporation, the Code imputes a deemed royalty for the license of these intangibles contributed to the Mexican corporation.²¹ As a result, USCO will have to impute license income annually based on the transfer pricing rules for intangible property.

By analyzing the incorporation of any foreign operations, the tax professional can avoid surprises in the form of recaptured or imputed income.

Extraterritorial Income Regime

U.S. exporters, such as USCO, should take advantage of the tax benefits offered by the extraterritorial income (ETI) exclusion.²² Unlike the FSC benefit, which required USCO to form and operate a foreign entity that had little substance, the ETI exclusion is easier to apply. USCO generally will exclude a portion of its foreign income under one of the following two tests: 15 percent of foreign trade income or 1.2 percent of foreign trading gross receipts.²³

Despite the ease of simply excluding a portion of income, USCO's tax professional should ascertain that USCO exports qualifying foreign trade property, USCO satisfies the required economic processes and USCO has sufficient foreign tax credit limitation.

To be qualifying foreign trade property,²⁴ the property can have no more than 50 percent of the value of the final product attrib-

utable to foreign labor costs and foreign components. USCO must further sell the property for use outside the United States.

The economic process requirements include the participation in sales test and the foreign direct costs test.²⁵ In addition to ensuring that these tests are satisfied annually, the tax professional may consider preparing a manual so that operational personnel will understand exactly what has to be done to obtain the ETI exclusion.

As aforementioned, the foreign tax credit is limited by the amount of foreign source taxable income that USCO earns. The ETI exclusion may reduce foreign source income and, consequently, the foreign tax credit limitation.

Foreign Investment in Real Property Tax Act (FIRPTA)

When USCO purchases either real estate or shares from a foreign seller, FIRPTA may apply to impose a withholding tax on 10 percent of the purchase price.²⁶ The FIRPTA withholding provisions were designed to prevent foreign sellers of U.S. real estate (over whom the IRS has no collection jurisdiction) from selling U.S. real estate without ever paying U.S. tax.

Although tax professionals often identify the FIRPTA issue when a foreign seller sells U.S. real estate to a U.S. purchaser, FIRPTA may also apply when a foreign seller sells shares in a U.S. corporation to a U.S. purchaser.²⁷ If U.S. real estate comprises over 50 percent of the U.S. corporation's fair market value, then the U.S. entity is a U.S. Real Property Holding Corporation and FIRPTA will apply. For example, suppose USCO is concerned about maintaining a stable supply of zinc,

which is a crucial ingredient in the manufacture of widgets. As a result, USCO purchases Zinc King, a U.S. corporation, from its United Kingdom parent. If over 50 percent of the value of Zinc King is comprised of U.S. real estate holdings, Zinc King is a U.S. Real Property Holding Corporation, FIRPTA applies and USCO must withhold 10 percent of the purchase price.

The tax professional should determine whether any U.S. corporations purchased from foreign sellers constitute U.S. Real Property Holding Corporations. If so, the purchases are subject to FIRPTA and USCO must comply with the appropriate withholding requirements.

Compliance

The tax professional must ensure that Forms 5471 are prepared for each foreign subsidiary. The penalty for failure to file the Form 5471 is \$10,000 for each omission.²⁸

Suppose, for example, that USCO owns a Netherlands holding company that owns second tier foreign operating subsidiaries in the United Kingdom, Germany and France. USCO would not be able to file merely one Form 5471 for the Netherlands holding company, but would have to file four Forms 5471 with its annual return—one for the Netherlands holding company and one for each of the three foreign operating subsidiaries.

USCO would only be able to avoid the penalty for failure to file a Form 5471 by showing that USCO had reasonable cause.²⁹ To show reasonable cause, USCO would have to make an affirmative showing of all the facts alleged as reasonable cause in a written statement containing a declaration made under penalties of perjury.

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¹³ The insured may be a senior generation member who provided the funds. If death was to occur while that individual had an ownership interest in the policy, then the proceeds will be subject to estate tax under Code Sec. 2033 or Code Sec. 2042 if there was deemed to be another incident of ownership.

¹⁴ *Id.*

¹⁵ WILLIAM SHAKESPEARE, *ROMEO AND JULIET*.

College Education

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⁷¹ Code Sec. 530(d)(4)(iii).

⁷² Code Sec. 530(d)(4)(iv).

⁷³ Code Sec. 529(c)(3)(C)(ii).

⁷⁴ Code Sec. 529(e)(2)(A).

⁷⁵ Code Sec. 529(e)(2)(D).

⁷⁶ Code Sec. 529(e)(2)(B) and (C).

⁷⁷ Code Sec. 152(a).

⁷⁸ Code Sec. 529(c)(5)(B).

⁷⁹ Code Sec. 135(c)(1)(B).

⁸⁰ Code Sec. 135(b)(1).

⁸¹ Code Sec. 135(b)(2) and Rev. Proc. 2001-59, *supra* note 9, for the current inflation-indexed amounts.

⁸² Code Sec. 135(c)(4).

⁸³ Code Sec. 135(c)(2).

⁸⁴ Code Sec. 135(c)(2)(A).

⁸⁵ *Id.* Eligible educational institutions are the same institutions that qualify under the Code Sec. 529 rules per Code Sec. 135(c)(3).

⁸⁶ Code Sec. 135(c)(2)(B).

⁸⁷ Code Sec. 135(d)(1). This includes tuition waivers as a result of using credits purchased under a prepaid Code Sec. 529 plan per Code Sec. 135(d)(1)(D).

⁸⁸ Code Sec. 135(d)(2).

⁸⁹ Both of these provisions were changed in Act Sec. 412 of PL. 107-16, *supra* note 40.

⁹⁰ Code Sec. 221(b)(1).

⁹¹ Defined in Code Sec. 221(b)(2)(C).

⁹² Code Sec. 221(b)(2)(B). The dollar limitations for modified AGI will be adjusted annually for inflation after 2002. Code Sec. 221(f). Married couples must file a joint return in order to be eligible for the deduction. Code Sec. 221(e)(2).

⁹³ Code Sec. 221(c).

⁹⁴ Notice 97-60, *supra* note 29, Section 5, Question 10.

⁹⁵ Costs include tuition, room and board, fees, equipment, and transportation. Notice 97-60, *supra* note 29, Section 5, Question 3.

⁹⁶ For purposes of the student loan interest deduction, eligible institutions also include those that offer residency or internship program that lead to a degree or certificate from a higher educational

institution, hospital or healthcare facility which offers postgraduate training. Code Sec. 221(d)(2).

⁹⁷ Code Sec. 221(d)(2).

⁹⁸ Code Sec. 221(d)(3).

⁹⁹ Code Sec. 221(d)(1)(B).

¹⁰⁰ Code Sec. 221(d)(1)(A).

¹⁰¹ Notice 97-60, *supra* note 29, Section 5, Question 7.

¹⁰² Code Sec. 221(d)(1).

¹⁰³ Notice 97-60, *supra* note 29, Section 5, Question 2.

¹⁰⁴ *Id.*

¹⁰⁵ Normally, the child would be the beneficiary of the plan. However, the taxpayer may be calculating these deductions and credits based upon his own (or his spouse's) educational expenses.

¹⁰⁶ Code Sec. 135(c)(4).

¹⁰⁷ Code Sec. 221(b)(2).

¹⁰⁸ Code Sec. 222(b)(2)(C).

¹⁰⁹ Code Sec. 25A(d)(3).

¹¹⁰ Code Sec. 530(c)(2).

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USCO would have to file this document with the appropriate IRS Service Center, whose Director has discretion to decide if reasonable cause existed and, if so, the duration it existed.³⁰

The tax professional should also review the filing of any Forms 5472 for each 25 percent foreign owner of USCO and every related party to each 25 percent foreign owner. Although the Form 5472 is not as detailed as the Form 5471, careful review is important because the Form 5472 is often the starting point for the IRS's examination of transfer pricing issues. The penalty for failure to file a required Form 5472 is also \$10,000. As with the failure to file a Form 5472, USCO may avoid a penalty by showing reasonable cause.³¹

Conclusion

By thoroughly conducting a review of these international issues, the tax professional will achieve two goals.

First, the tax professional will ensure that, from an international perspective, USCO's books and records are audit proof or will at least appear to be so to the IRS. Second, the tax professional will be able to spot a few planning opportunities that will help decrease USCO's overall effective tax rate. Although the level of complexity involved with the international review of these issues will vary with the size and complexity of USCO, conducting this overall review will enable the tax professional to plan properly for the continued globalization of business.

ENDNOTES

¹ Repatriation refers to the concept of bringing cash back to the owner's country.

² Code Secs. 951-960.

³ Code Sec. 954(d).

⁴ Code Sec. 954(c).

⁵ Code Sec. 954(e).

⁶ Code Secs. 1291-1298.

⁷ Code Sec. 902.

⁸ Code Sec. 904(d).

⁹ Reg. §1.905-2(a)(2).

¹⁰ Reg. §1.905-2(b).

¹¹ Code Secs. 861(a)(6) and 862(a)(6).

¹² Code Sec. 863(b); Reg. §1.863-3(b).

¹³ Code Sec. 482.

¹⁴ Reg. §1.482-3.

¹⁵ Reg. §1.482-4.

¹⁶ Reg. §1.482-2(a).

¹⁷ Reg. §1.482-2(b).

¹⁸ Code Sec. 6662(e).

¹⁹ See, e.g., *Fowler v. Minister of National Revenue*, 90 D.T.C. 1834; [1990] 2 C.T.C. 2351, where the Tax Court of Canada found a salesman from Seattle who annually visited a week-long trade show in Vancouver as constituting a permanent establishment.

²⁰ Code Sec. 367(a).

²¹ Code Sec. 367(d).

²² Although the World Trade Organization has ruled that the ETI exclusion is an illegal subsidy, the ETI exclusion remains part of the Code until legislated away by Congress.

²³ Code Sec. 941(a).

²⁴ Code Sec. 943(a).

²⁵ Code Sec. 942(b).

²⁶ Code Secs. 897 and 1445.

²⁷ Code Sec. 897(c)(2).

²⁸ Code Sec. 6038; Reg. §1.6038-1.

²⁹ Reg. §1.6038-2(k)(3)(i).

³⁰ Reg. §1.6038-2(k)(3)(ii).

³¹ Reg. §1.6038A-4(b).