DON'T PAY TAX
TWICE ON EACH DOLLAR OF EARNINGS!

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How to Avoid Double Taxation and Membership in the "100 % Club"

Many experienced entrepreneurs, investors and business owners who have successfully operated in the past in their local environment are unaware of the tax pitfalls involved in cross-border transactions. It is easy to fall prey to serious missteps and to pay tax to more than one government for the same dollar of earnings. By not taking the appropriate steps to avoid double taxation a business can easily find itself with an effective tax rate much higher than the US maximum corporate rate of 35%. In certain outrageous cases, the tax rate can be as much as 100% of profits earned!

Alternatively, an internationally savvy entrepreneur can obtain the maximum use of his foreign tax credits and grow his business with "before tax dollars" by taking advantage of deferral provisions that is to say, not paying either US or non-US taxes currently on income earned. Can this be accomplished and is it legal?

The answer is "yes" to both questions - but there are many complexities. The entrepreneur must understand the way in which governments limit their taxing rights. The US asserts its taxing right broadly on the "worldwide income" of its citizens, residents and corporations. That is, it taxes all income earned by its citizens, foreign nationals living in the US and businesses incorporated here, without regard to where in the world the income was earned. This is in contrast to the territorial system used by many other countries, which taxes only the income earned on their soil.

The Good News
Having asserted that broad right to tax, the US then proceeds to unilaterally limit or restrict its tax collection in a number of ways. The rules governing these limitations provide an opportunity to reduce or eliminate double taxation and defer payment of US tax indefinitely and thereby reduce the overall effective tax rate on profits.

The Bad News
To limit tax abuse and to prevent the erosion of the US tax base, the government also imposes a further set of rules designed to limit the amount of foreign tax credits that are allowed in any one year and to restrict the ways that a business can defer paying tax on foreign income.

Why Good Planning is Key
In other words, the rules and restrictions that apply to the foreign tax credit and deferral provisions are complex and difficult to navigate. Skill and experience are needed to help a global start-up stay out of the "100 % club" – the club of unfortunates that, because of the double impact of US and overseas taxation, wind up owing 100 % of their profits, or more, in tax liability. Looking at it another way, effective international tax planning can be yet another form of a competitive advantage for an entrepreneur, over competitors that are not as knowledgeable or skillful in the development of international tax strategies.

The challenge for entrepreneurs is to steer clear of the pitfalls created by the "tax avoidance provisions," while taking advantage of all the benefits allowed to avoid double taxation and the deferral of tax on un-repatriated foreign earnings. In the following sections, we look at opportunities and pitfalls for global start-ups as they confront the complexities of international taxation.

Help with the Elimination of Double Taxation

There are several mechanisms the US uses to reduce the tax burden:

- Elimination of tax: This is the simplest mechanism. The foreign tax credit provides a direct credit for foreign taxes against the US tax liability.

- Deferral or postponement of current US tax on the foreign earnings of controlled foreign corporations: Generally, earnings of a foreign subsidiary are not taxed until dividends/distributions are made to the US parent, or when a gain is realized upon the sale of the stock of a corporation or upon liquidation.

- Reduction of tax: Special deductions and exemptions are issued, such as the exemption for certain earned income of qualified US citizens or US residents living abroad or allows foreign tax credits more broadly than the statute.

- Treaties: There are a number of agreements among nations where the US relinquishes or limits certain taxing rights.

Since many of these rules are formalistic in nature, various tax results can be achieved by similar businesses based on the manner they have structured their business and the extent and type of tax planning they have done. In this respect, international tax planning can be a competitive advantage for an entrepreneur, vis-à-vis its competitors.

Challenges with Limitations on Tax Avoidance

With one hand the US giveth, with the other, it taketh away. While unilaterally limiting its authority to tax, the US over the years has continued to tighten enforcement on perceived abuses that were seen to be eroding the US tax base. It has curtailed many tax avoidance techniques involving income earned offshore.

Generally, a US corporation operating abroad via a branch must pay tax in the US, in the current year on its worldwide income, and can use some or all of the foreign taxes paid to host governments as a credit to reduce its US tax payment. If, however, a US corporation is operating abroad through a foreign corporation, then US taxation is deferred until a dividend/distribution is made by the foreign corporation. Therefore, one of the main goals of the tax avoidance provisions was to eliminate or restrict the ability of corporations to defer the payment of US tax on current foreign earnings.

Since the Kennedy era, elaborate rules called *Subpart F* have been enacted, designed explicitly to reduce or eliminate deferral on certain types of income. A particular focus of the rules was the set of techniques (described below) by which a company "shifted" certain types of income to a company offshore in a low taxed jurisdiction.

> For instance, certain income known as *foreign personal holding company income* can no longer be used to shelter income from passive investments in a low taxed jurisdiction. Other base company income includes *foreign base company sales* or *foreign base company services* income. Such income is generated from triangular sales or services, where one leg of the transaction is between related parties. Such triangular transactions could be used to shift income to a low-tax jurisdiction by manipulating the prices that the related parties charged each other for the activities or services rendered.

In another scenario under the Subpart F rules, it becomes impossible to defer tax if the foreign corporation's earnings are invested in the US. Such investments are considered to be the economic equivalent of a deemed dividend to the US parent. As with a true dividend, the amount of the investment is considered taxable in the current year even though no actual dividend was declared or paid.

Yet another technique that was used to shift income out of the US – until it was specifically disallowed – was to transfer appreciated property out of the country. This was known as the *outbound transfer*.

> Intellectual Property
>
> Of particular note to global start-ups is the treatment of outbound transfers of intangible assets such as intellectual property (IP). This has been specifically forbidden in the tax avoidance rules. When intangibles are transferred to a controlled foreign corporation, the company is treated as having sold the intangible at fair market value in exchange for royalties over the life of the property. Fair market value is determined based on the income attributable to the intangible. Why such a harsh treatment? The reason is that deductions and tax credits for development expenses were allowed against US taxable income while the future resulting income would be deferred indefinitely from current US taxation. Obviously, US tax authorities want to prevent that from happening.

The US Foreign Tax Credit in Action

Therefore, in structuring foreign operations and in seeking to minimize the overall effective tax rate of a company, global start-ups must "walk the line" between the hazards of the "tax avoidance provisions" and the benefits of tax credits and tax deferral, in order to minimize their tax liability.

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How best to do this? How does the foreign tax credit operate in practice? These four examples illustrate different situations. As can be seen, the overall effective tax rate on profits varies dramatically – from 35% to 70 % – depending on the underlying structure of the operations and the transactions.

Example 1: The tax rate in the US and the foreign country is the same

	Total	US source	Foreign Source
Net Income	100	0	100
Foreign Tax 35%	35		35
US Tax 35%	35		35
Foreign Tax Credit	(35)		
Total Tax Paid	35		

By claiming a US Foreign Tax Credit, the start-up avoids double taxation. It pays only the overseas tax of 35, claims a US tax credit of 35 and pays no US tax.

Example 2: The tax rate in the US is higher than in the foreign country

	Total	US source	Foreign Source
Net Income	100	0	100
Foreign Tax 20%	20		20
US Tax 35%	* 35		35
Foreign Tax Credit	* (20)		
Total Tax Paid	35		

* An additional tax of 15 is paid in the US (35 less credit of 20)

The US Foreign Tax Credit cannot exceed foreign taxes paid on foreign source income (FSI) and the foreign income is then taxed up to the US rate. Here the start up pays an overseas tax rate of 20 %, receives a US foreign tax credit in that amount, and is liable for the 15 % difference between the overseas rate and the US rate. In total the company pays a tax equivalent to the full US rate, but most goes to the overseas jurisdiction. Again, double taxation is avoided.

Example 3: The tax rate in the US is lower than in the foreign country

	Total	US source	Foreign Source
Net Income	100	0	100
Foreign Tax 45%	45		45
US Tax 35%	* 35		35 Limit
Foreign tax credit	* (35)		
Total Tax Paid	45		

* No additional tax is paid in the US (35 less credit of 35)

The US Foreign Tax Credit cannot exceed US tax on foreign source income (FSI). Here, the liability is higher in the overseas jurisdiction. The start-up receives a US credit of 35 against the full amount of the US liability, but is still required to pay the full overseas liability of 45, which is higher than the US liability would have been. Still, there is no double taxation – the company pays the full overseas amount of tax, and receives a credit for what would have been the full US amount.

Example 4: The transactions have not been properly structured and there is insufficient "foreign source income generated"

	Total	US source		Foreign Income treated as U.S. source
Net Income	100	100	←	100
Foreign Tax 35%	35			35
US Tax 35%	35	35		
Foreign tax credit	0			
Total Tax Paid	70			

Here, a sales contract has not been properly drafted and although a foreign government has taxed the income incurred in its country, this offshore income is not considered by the US to be foreign source income for tax purposes. If the transactions have not been structured for optimal tax performance, then the start-up pays the price in the form of double taxation. The US Foreign Tax Credit is only available against foreign tax on foreign source income (FSI). It is not available on US source income. Here, the US asserts its right to tax “worldwide income” of US citizens and businesses no matter where it is earned. But the overseas tax authority applies its territorial approach to tax income earned within its borders. The start-up owes tax to both the US and the overseas authority, and winds up paying 70 % of its income in total tax liability. Proper planning and structuring of transactions might have converted the US source income into foreign source income, thereby allowing the overall tax rate to drop from 70 % to 35 %.

Conclusion

Clearly, the skillful application of the US Foreign Tax Credit can result in substantial reduction of tax liability for companies doing business overseas. But there are many pitfalls. Subpart F restrictions are difficult to understand, and if missed, they can negate the positive effects of the credit. In the worst case scenario, the start-up may wind up owing a double tax and paying out all if not most of its profits in taxes, thus becoming a member of the 100% club!

A full service accounting firm with international experience can assist entrepreneurs developing global start-ups by developing effective strategies to minimize tax liability in global operations. Such a firm can and should be engaged to work alongside your legal team.

For More Information

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