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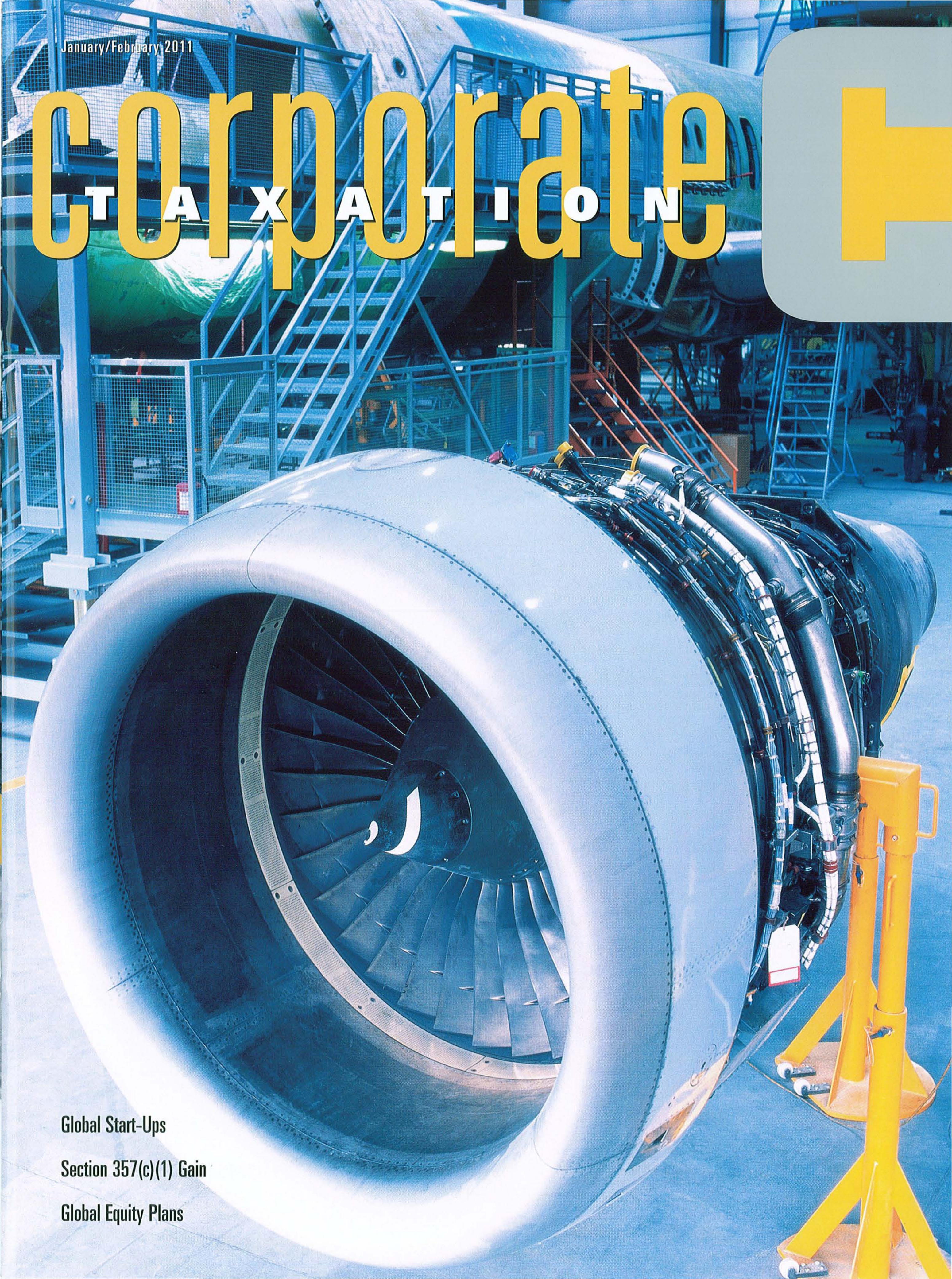
corporate TAXATION



Global Start-Ups

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Global Equity Plans

INTERNATIONAL TAX PLANNING—AN ESSENTIAL STEP FOR GLOBAL START-UPS

JEANNE P. GOULET

The same turbulence that has challenged the global economy has also created pockets of opportunity around the world. Simultaneously, entrepreneurship is at a high, as recent college graduates create their own opportunities, as layoffs at senior levels transform executives into entrepreneurs. And the evolution of technology, along with the booming growth of worldwide networks, has made it possible for those same entrepreneurs to launch businesses that can operate immediately on an international basis. Now, as never before in history, a business can be "global from birth."

But predictably, as in all entrepreneurial ventures, with opportunity comes significant risk. Planning, launching, and growing a start-up are complex tasks—all the more so when the start-up must operate from the beginning on a global scale. To be successful, the founders must be prepared for an intensive, accelerated, and ongoing planning process. They face a series of critical decisions that will determine success or failure.

Questions they must anticipate and address include how to structure the business and what jurisdiction to incorporate in. Predictably, much of their effort must be directed at tax planning. The leader of a global start-up must determine almost immediately how to plan for taxation in multiple worldwide jurisdictions. Failure to engage in comprehensive up-front planning can lead to tax consequences so severe that they can put the fledgling start-up out of business.

Consultation with legal and accounting professionals well versed in international taxation and global commerce should be among the first items on the entrepreneur's "to do" list. These professionals can provide guidance through the labyrinth of tax rules and regulations. Taking this step in the early stages will help ensure that pitfalls are avoided and the business can grow unencumbered by the mishandling of international tax.

At the outset, the global entrepreneur needs to address two basic but far-reaching questions: *What should I be?* and *Where should I base my operation?* That is, how should the entity be structured? What are the tax consequences of establishing a headquarters in one jurisdiction vs. another? Embedded in the second question is another critical issue: *How can I effectively avoid paying double tax, or worse, being taxed at 100% of my income?* Membership in the "100% club" is something to be avoided if at all possi-

In many respects, the time has never been better to launch a global start-up.

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ble. There are several remedies for double taxation, among them the effective use of the U.S. foreign tax credit.

Much as the process is challenging, effective international tax planning can also provide 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. In other words, if entrepreneurs put the effort into tax planning early on, they will find that the extra work involved is amply rewarded.

The following provides an overview of major tax issues for global start-ups, and outlines methods for arriving at an optimal financial structure while minimizing overall tax liability.

How should the entity be structured?

A start-up founder/CEO can select from two main options to house the entity—a *corporation* or a *transparent entity* (pass through entity).

In the United States, the income of a "C" corporation is taxed twice—once at the corporate level and then again when the net-after-tax-earnings are distributed as dividend income to the shareholder.

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Alternatively, a start-up might begin as a transparent entity, such as a partnership, a limited liability company or a U.S. Subchapter S corporation. These entities generally do not pay income tax on their income because the owners include their share of the start-up's income in their own tax returns. At present, the maximum federal tax rate for individuals is 35% (not including payroll tax), thus tax on the start-up's distributed earnings can be significantly reduced by beginning operations as a fiscally transparent entity. Subject to limitation, business losses incurred by a transparent entity, which can be significant in an entity's early years, might be deductible by the start-up's owners against other sources of income.

Where should the operation be based?

The entrepreneur needs to think about three main options for locating the business. *In the United States? Somewhere in Europe? In a low-tax rate jurisdiction?*

When start-ups aspire to go global, they often overlook the impact that international tax structures and offshore operations will ultimately have on their operations and on their investors. Start-ups need to understand the implications and take proactive measures that will help avoid double taxation and minimize their overall effective tax rates.

There are multiple ways of approaching international tax structures. If the start-up will initially operate in the United States, it might still be beneficial to form the start-up in a foreign jurisdiction at the very outset. In the case of a start-up that is developing intangible assets, for example, it can be very costly to transfer such assets to a related offshore entity at a future time when value has been created. Therefore, it might be beneficial to have the intangibles owned initially by an offshore entity, even though intangible development is being performed at an arm's length price by a related U.S. entity.

Jurisdiction plays perhaps the most critical role in the tax structure of a business. The Internet provides boundless and borderless opportunities. When launching an Internet or e-commerce business, there is a strong possibility that a start-up will be global—in one way or another. For example, a business may license software or have sales in non-U.S. jurisdictions or it may outsource some of its development to India, the Ukraine, or Israel. Conversely, there may be a non-U.S. parent company, say in Israel or Europe, which has set up a branch or a subsidiary in the U.S. These types of arrangements categorize a start-up as a "global business."

Therefore, an entrepreneur must understand the basic aspects of international tax law that will govern which countries have the right to tax the future profits of not only the business but also its owners and employees. The entrepreneur needs to know what activities will create a "taxable presence" on a state or federal level. In addition, the entrepreneur needs to understand which countries will provide tax benefits, tax holidays and the use of current tax losses.

Nationality and territoriality

The first step to deciphering international tax law is to understand the concept of jurisdiction. Jurisdiction defines the "taxing rights" of a country, over people and transactions. Taxing rights are generally imposed based on two overriding principles: *nationality* and/or *territoriality*.

Nationality for individuals is easy. It depends on citizenship. A citizen of the U.S. is a person born or naturalized in the U.S. Nationality for a U.S. corporation, however, depends on where incorporation took place. The U.S. taxes its citizens, non-citizens who are U.S. residents, and corporations that were incorporated in the U.S. on their worldwide income regardless of where they do business. It should be noted that the U.S. is one of the few countries that bases jurisdiction to tax on "nationality."

Territoriality, on the other hand, depends on the location of people, property, income, or wealth. Countries that utilize a territorial system of taxation impose tax on business profits of a nonresident earned within their country as well as investment income arising within their country such as dividends, interest, royalties, and rents. Income earned by residents outside the country is not subject to local tax under a territorial system.

Outbound vs. inbound

Understanding taxing rights of various countries is only one piece of the jurisdiction puzzle. An entrepreneur must also understand how the movement of a start-up's business transactions is characterized—a concept that is often thought of in terms of "*outbound*" *vs.* "*inbound.*"

In the case of an outbound transaction from the United States, U.S. citizens, residents, and corporations are conducting business and investing outside of the U.S. Such investments can take place directly or through U.S. or foreign corporations, partnerships, or other types of entities. As mentioned above, the U.S. will tax only citizens, residents, and domestic corporations on their worldwide income. Income of transparent entities such as partnerships would be taxed to the owners.

Alternatively, with an inbound transaction, non-resident aliens or foreign corporations are operating or investing in the U.S. Generally, such entities are not subject to U.S. taxation on their worldwide income. Rather, they are taxed under a territorial concept based either on U.S. net taxable income or on U.S. gross income. Gross income, representing non business or investment income in the U.S. is taxed at a rate of 30%, unless such rates are reduced by application of an income tax treaty entered into with the non-resident's home country.

Avoiding double taxation and membership in the '100% club'

Understanding the basis of a country's taxing rights helps to better understand the types of situations that could lend themselves to double taxation.

Imagine a tournament of "World Cup Soccer" where each referee uses a unique local rulebook. Conflicts would inevitably arise. In international tax law, the game is no different. Conflicts among countries with unique taxing rights arise and can result in double taxation for the taxpayer. In fact, if not addressed correctly, taxes can be imposed by numerous jurisdictions—possibly resulting in an overall tax rate in excess of 100% of profits!

Membership in the '100% club' is something to be avoided if at all possible.

Double taxation can present itself in a variety of different scenarios such as:

- **Multiple countries assert taxing rights over the start-up:** Two countries each claiming that the start-up is a resident and taxable in their respective country.
- **Multiple countries assert taxing rights over the transaction:** Two countries claim that the income from a particular transaction is earned in and should be taxed by each country.
- **Split tax assertion over party and transaction:** One country claims that it is entitled to tax the start-up because it is a resident of its country and the other country claims that it has the right to tax because the transactions are taking place within its borders.

How to avoid the pitfalls

While most taxpayers are motivated to reduce double taxation, most countries are motivated to maximize their revenue, especially during economic downturns. Yet, the international tax world is not the "Wild West." Government efforts exist to alleviate double taxation in order to promote international trade.

Through coordination among countries directly with each other or via membership in organizations such as the Organization for Economic Co-operation and Development (OECD), efforts are made by governments and businesses to minimize international conflicts and provide a fair sharing of the global tax pie.

Unilateral methods. The following unilateral methods can help start-ups alleviate double taxation.

- Some countries do not tax foreign income of their citizens, residents, or corporations.
- Other countries offer a credit for foreign taxes paid on income earned abroad. In addition, some countries offer a deduction for foreign taxes paid rather than a credit.

Bilateral methods applied via tax treaties. Treaties generally provide reduced tax rates on certain types of income. To claim the benefit of the treaty, tax returns may nevertheless be required in the U.S. merely to obtain a reduced rate or a zero rate of tax. Treaties also provide common definitions for terms including:

- What constitutes residence versus physical presence?
- How should the source of income be characterized?
- Establishing a priority for the rights of a country to impose tax on income earned within its country on a territorial basis, leaving merely residual rights to the country that asserts jurisdiction on the basis of nationality.
- Finally, when conflicts among nations occur, a method has been established for negotiating conflicts through a "competent authority."

Making effective use of the U.S. foreign tax credit

The idea of foreign tax credits is worth expanding on. A significant opportunity to avoid double taxation presents itself in the form of effective use of the U.S. foreign tax credit.

An internationally savvy entrepreneur can obtain the maximum use of foreign tax credits and grow the business with "before tax dollars" by taking advantage of deferral provisions—that is to say, not paying either U.S. or non-U.S. 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. Once again, the U.S. 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 U.S., 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 U.S. 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 U.S. 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 U.S. 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. As in all foreign tax planning, skill and experience are needed to help a global start-up stay out of the "100% club."

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.

Help with the elimination of double taxation

There are several mechanisms the U.S. 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 U.S. tax liability.
- **Deferral or postponement of current U.S. 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 U.S. 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 U.S. citizens or U.S. residents living abroad or allows foreign tax credits more broadly than the statute.
- **Treaties:** There are a number of agreements among nations where the U.S. relinquishes or limits certain taxing rights.

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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 also, international tax planning can be a competitive advantage for an entrepreneur, vis-à-vis competitors.

The challenges of limitations on tax avoidance

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

Generally, a U.S. corporation operating abroad via a branch must pay tax in the U.S., 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 U.S. tax payment. If, however, a U.S. corporation is operating abroad through a foreign corporation, U.S. 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 U.S. 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 U.S. Such investments are considered to be the economic equivalent of a deemed dividend to the U.S. 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 U.S.—until it was specifically disallowed—was to transfer appreciated property out of the country. This was known as the *outbound transfer.*

The U.S. foreign tax credit and intellectual property

The treatment of outbound transfers of intangible assets such as intellectual property (IP) is particularly worth noting. 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 U.S. taxable income while the future resulting income would be deferred indefinitely from current U.S. taxation. Obviously, U.S. tax authorities want to prevent that from happening.

The main imperative—'Walk the Line'

Taking all the provisions of the U.S. foreign tax credit into account, it becomes evident that, 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. Clearly, the skillful application of the U.S. 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.

Conclusion

Start-ups and their founders/owners/investors who are engaged in borderless Internet and e-commerce transactions, outsourcing development of intellectual property, or whose ambition is to establish a beachhead in another country and to become globally relevant, must deal with issues of tax jurisdiction, not only for the business but also for themselves and their employees. The complexities and conflicts among international tax laws effectively require that an international tax practitioner be a member of the advisory team.

The right time to engage in international tax planning is when the company is being formed. The appropriate form of legal entity for international operations located in the U.S. or abroad; the necessity to establish potential subsidiary entities in multiple countries to minimize the worldwide effective tax rate can best be achieved when the start-up is being formed. It is possible to restructure an existing business structure but it can be very expensive and the result will seldom be optimal. When the start-up is in a pre-revenue phase, an international tax plan may, under certain circumstances, be customized so that it is phased in, as revenue is generated, provided the foundation has been set up properly at the outset.

An entrepreneur thinking about starting a business—domestic or global—is well-advised to seek the assistance of a full service accounting firm with international expertise that can work with the entrepreneur's legal team and help guide them through the process.

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 the entrepreneur's legal team. ■