THE GLOBAL START-UP
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A LOOK AT JURISDICTION: Who Will Tax My Business?

You've weighed the entity options for your Start-Up. You now understand the tax differences between corporations and transparent entities and the impact they could ultimately have on your bottom line. You think you have a strong sense of where you want to set-up your legal entity. Or do you?

Jurisdiction plays perhaps the most critical role in the tax structure of a business.
As we know, the Internet provides boundless and borderless opportunities. When launching an Internet or e-commerce business, there is a strong possibility that your Start-Up will be global – in one way or another. For example, you may license software or have sales in non-US jurisdictions or you may outsource some of your development to India, the Ukraine or Israel. Conversely, you may have a non-US parent company, say in Israel or Europe, who has set up a branch or a subsidiary in the US. These types of arrangements categorize your 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. 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 US is a person born or naturalized in the US. Nationality for a US corporation, however, depends on where incorporation took place. The US taxes its citizens, non-citizens who are US residents and corporations which were incorporated in the US on their worldwide income regardless of where they do business. It should be noted that the US 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, US citizens, residents and corporations are conducting business and investing outside of the US. Such investments can take place directly or through US or foreign corporations, partnerships or other types of entities. As mentioned above, the US 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 US. Generally, such entities are not subject to US taxation on their worldwide income. Rather, they are taxed under a territorial concept based either on US net taxable income or on US gross income. Gross income, representing non business or investment income in the US 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.

Double Taxation: What Are Some Common Scenarios?

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!

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

1. **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

2. **Multiple countries assert taxing rights over the transaction**: two countries claim that the income from a particular transaction is earned and should be taxed by each country

3. **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 reduce the loss of their revenue base, 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.

The following unilateral and bilateral methods can help Start-Ups alleviate double taxation:

Unilateral methods

- Some countries do not tax foreign income of its citizens, residents or corporations
- Other countries offer a credit or dollar-for-dollar offset for foreign taxes paid abroad on income earned abroad. In addition, some countries offer 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 US 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 the source of income should 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"

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 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 US 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.

If you are an entrepreneur thinking about starting a business – domestic or global – you are well-advised to seek the assistance of a full service accounting firm with international expertise that can work with your legal team and help guide you through the process.

FOR FURTHER INFORMATION

For more information or to set up an appointment with a team of MP&S specialists, please contact **Jeanne P. Goulet, CPA, Senior Tax Consultant** at MP&S at 212.710.1816 or jgoulet@markspaneth.com.

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