Going Global: International Tax Issues for Small and Mid-Size Companies

~ Michael J. Wilson

Small and mid-size companies are continuing to expand their businesses globally at an ever-increasing rate. In the early stages of global business expansion, companies may export products or provide services to customers in foreign markets. Companies may expand their global footprint by opening a sales office, warehouse, or a facility for performing warranty or repair services in a foreign country; constructing or acquiring a foreign manufacturing facility; or purchasing a competing or complementary business in a foreign country. From a legal perspective, global expansion can have many forms, structures, and functions, including creating contractual relationships with distributors or licenses; establishing international legal entities for sales, manufacturing, or other business functions; or entering into an international joint venture.

If your company is considering expansion into a foreign market, then besides a host of business and regulatory issues you face, you must also consider complex United States and foreign tax issues. While small and mid-size companies can now have the global footprint of a giant multinational corporation, they do not have the same technology and resources to handle the multinational tax compliance issues and planning opportunities. Before we analyze those tax issues, there are several fundamental tax-related questions to consider, including:

1.

Will your company open a sales office, buy a manufacturing plant, establish a foreign legal entity, or enter into a joint venture with a foreign partner? If the company establishes a foreign legal entity, what type of entity should you use?

2.

How will you finance the foreign operations?

3.

How will profits you earn from a foreign country be taxed in that country, if at all?

4.

Will the foreign profits be taxed in the US when earned or when repatriated to the US?

5.

How can profits from the foreign operations be repatriated to the US?

6.

What is your exit strategy and what are its tax implications?

While a full discussion of all of these questions is beyond the scope of this article, the questions serve as a framework for analyzing some of the key tax aspects of going global.

Tax Systems

Unlike the United States, most foreign countries have a territorial tax system. A territorial tax system generally imposes little or no additional tax in the home country on active business income earned outside that country until those earnings are repatriated to the home country.

The United States is one of the few developed countries that taxes its companies and other tax-paying residents on their worldwide income regardless of the geographic location of the business. This is a "worldwide tax" system. Taxation in the US of the active business income of a foreign subsidiary of a US parent is often deferred until such earnings are repatriated to the United States through dividend payments. The United States income tax treaty network and foreign tax credit rules help to ameliorate double taxation in both the foreign country where the business is located and in the United States where the business is ultimately owned.

There are also several countries that provide very low tax rates, such as Ireland, Hong Kong, Singapore, and the British Virgin Islands, or even no income tax at all, such as the Cayman Islands and Bermuda. It is becoming more difficult under US law to develop and implement legal structures to take advantage of these low-tax or no-tax jurisdictions.

Exporting

The simplest method for going global is to export goods to foreign customers. A US company merely sells goods ordered by foreign customers via website, email, telephone, or fax. The US company may even have an independent sales representative in the foreign country to solicit orders.

In general, export sales are taxable in the US but not in the country where the goods are shipped. However, where the US company has a permanent establishment (PE) in a foreign country, then sales to customers in that country may be subject to tax in such foreign country. A PE is a specific tax-treaty term and is generally defined as a "fixed place of business," including a branch office, sales office, or factory. There are several exceptions, including facilities used solely to store, display, or deliver goods. A US company that has an agent in the foreign country—one with the ability to contract on behalf of the US company—may also constitute a PE in such foreign country.

Where the US exporter has no PE, there may be an opportunity to take advantage of the IC-DISC export tax incentive. An IC-DISC, which stands for "interest charge domestic international sales corporation," is generally a US corporation set up specifically to qualify as an IC-DISC under tax rules by meeting an annual qualified export receipts test and qualified export assets test. Under these tests, at least 95 percent of the IC-DISC's gross receipts

and assets must be related to the export of property that comprises at least 50 percent US-produced content. The general tax effect of the IC-DISC is that the exporting US company pays tax-deductible sales commissions to the IC-DISC; the IC-DISC pays no income tax on these commissions; and when earnings are distributed by the IC-DISC to its owners, the owners are taxed on these earnings at the long-term capital gains rate (which can be as high as 23.8 percent) instead of the ordinary income tax rate (which can be as high as 39.6 percent). So in effect, the IC-DISC allows for the taxation of ordinary income at the lower long-term capital gains rate.

Licensing

Another common way for a US company to go global is for the company to license certain intellectual property, such as a trademark, patent, secret process, copyright, or franchise, to a foreign licensee in exchange for royalty payments. Sometimes US companies export to certain jurisdictions but license into others, depending upon the rules and restrictions in certain foreign jurisdictions.

Royalty income of a US recipient is often not taxed (or taxed at a relatively low rate) in the foreign country from which the royalty is received because of the network of income tax treaties that the US has entered into with most developed countries around the world. The royalty income would be subject to ordinary income tax rates in the US, but any foreign tax paid on the royalty income can generally be used as a credit against the US income tax under the foreign tax credit rules.

Establishing or Acquiring a Foreign Office or Manufacturing Facility

Often you will need a physical presence in a foreign market to manufacture, market, and sell goods effectively. Reasons for this could include reducing transportation costs, avoiding duties and tariffs, and meeting face-to-face with customers more readily. Sometimes a US company will want to start up its own office or facility, and at other times it will want to acquire a preexisting business or facility.

There are three common structures available for establishing or acquiring a foreign office or other facility in a foreign country. Your US company can directly establish the office or facility (commonly known as setting up a “branch office” of the US business); you can form a subsidiary legal entity, such as a corporation, in the foreign country to establish the foreign office or other facility; or your US company can directly, or indirectly through a US or foreign subsidiary, enter into a joint venture agreement with a foreign partner. These alternative structures have varying tax consequences that require considerable analysis.

If your US company opts to set up a branch office (or other facility constituting a PE) in the foreign country, then your company would continue to be taxed in the US on its worldwide income and would also be subject to taxation in the foreign country. This double taxation may be mitigated through the income tax treaty network and the US foreign tax credit rules. In addition, setting up a branch office subjects the US company to direct scrutiny in the foreign country and may subject that company to an additional

"branch profits tax" in the foreign country, depending upon the income tax treaty between the United States and such foreign country. However, if the branch office has a net loss, this may offset other income (domestic or foreign) of the US company.

If your US company establishes a foreign subsidiary, and if that foreign subsidiary directly or through a joint venture with a foreign partner establishes a foreign office or other facility, then your company will be shielded from taxation in the foreign country. Using a foreign subsidiary can also provide greater liability protection to the US company. The foreign subsidiary would pay tax on its income in the foreign country and file income tax returns in the foreign country. Generally, the profits of the foreign subsidiary would not be taxed in the United States until such profits are repatriated back to the United States, such as through the payment of a dividend by the foreign subsidiary to its US parent.[1] The dividend may be subject to withholding tax in the foreign country, depending upon the income tax treaty, but such tax would be credited against the US income tax imposed on such dividend.[2]

Financing Plan

Tax planning is a major consideration in determining your best strategy for financing a global business expansion. A common financing technique to reduce foreign income tax is the use of related company debt. For example, if you own a company in the United States, that company could loan funds to its foreign subsidiary, and, depending on the US income tax treaty, the interest payments could be tax-deductible in the foreign country and subject to little or no foreign country withholding tax. Depending upon the foreign country in which the company is located, other rules come into consideration, such as so-called "thin capitalization" rules that can limit tax-deductible interest, depending upon the borrower's debt-to-equity ratio. Many countries only permit interest to be tax-deductible where interest is reasonable and the debt otherwise has "market terms." Despite these limitations, related company debt is commonly used by US companies that have expanded into foreign markets.

Conclusion

Entering foreign markets can be very profitable, but navigating the risks and opportunities is complex. A successful global expansion strategy should integrate international tax considerations with business goals and objectives and regulatory issues. US businesses looking to expand into foreign markets have a host of tax and other legal issues to analyze. This analysis is especially complex because of the different tax and legal issues in different foreign countries—and this article briefly discussed only some of the primary tax issues to be considered.[3] Consequently, businesses must carefully analyze many issues because there is no "one size fits all" strategy for the most tax-efficient approach to global expansion.

[1]If a joint venture structure with a foreign partner is utilized, a special purpose entity, such as a corporation or partnership, should be used as the joint venture vehicle. The use of such an entity still requires a decision as to whether the US company should own an interest in the special purpose entities directly or through a foreign subsidiary.

[2]There is a large and complex set of rules relating to so-called "Subpart F income" that is a major exception to the deferral of US taxation of foreign subsidiary income. A discussion of these rules is beyond the scope of this article.

[3]Other issues include (1) entity tax classification for each foreign country; (2) transfer pricing issues when there are business relationships between related entities; (3) ways to maximize utilization of the foreign tax credit in the US; (4) ways to reduce foreign tax exposure through related entity payments, such as management fees and royalties; (5) avoiding US income tax traps, such as Subpart F income issues; (6) compliance with S disclosure rules related to foreign bank and other financial accounts; and (7) VAT (valued added tax) issues.

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