Outward Bound – Structuring Considerations for Closely Held Businesses Expanding Abroad

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First Thoughts

How It Gets Started

- A client tells you that his company has expanded internationally or has opportunities to do so. He has heard that Google and Apple pay 5% tax on their international operations. Do they do it? How do they do it? Why can't he do that? How can he do that?
- A client tells you that she is entering into a joint venture with "some people from abroad" and she would like to know how not to pay tax
- A prospective client says he is about to earn a large fee from a foreign client and would like to form an offshore company to earn the fee – is that a good idea?

What do you tell these clients? How do you keep them out of trouble?

Overview

- In this presentation, we will outline key rules applicable to a U.S. persons who establishes and operates a business abroad and show how they apply to closely held businesses
- Then, we will work through a series of structures through which such business might be conducted, focusing on the overall effective tax rates on income as it is earned and moved through and around each structure until fully distributed to individual U.S. shareholders
- The presentation uses the conduct of a manufacturing business in China as an example, but the principles are broadly applicable to foreign business activities in the developed world and in many developing countries which impose significant income taxes on business profits
- We conclude with a summary of key issues arising when intellectual property is a significant factor in the business

What We Do and Don't Cover

- **In a separate presentation, we will cover**
  - Planning for moving people around, especially owners and key executives
  - Selection of European holding company
  - VAT basics
- **We won't cover**
  - Tax compliance
  - Joint ventures
  - Foreign taxes and foreign tax planning
  - Most indirect taxes, foreign or domestic, sales and use taxes, customs and excise taxes (but see above re VAT)
  - Financing
  - Repatriation planning
  - The domestic and international politics of cross-border taxation
- In other words, we'll just be scratching the surface

Apples to Googles

- The key difference between a closely held business and Apple or Google is that big U.S. corporations are largely indifferent to the taxation of their shareholders
- That low rate, if it exists, does not take account of taxation of shareholders in many different shapes and sizes on fully distributed earnings or capital gains:
  - U.S. individuals, trusts and corporations
  - Tax exempt pension funds, retirement accounts and charities
  - Foreign individuals, corporations and governments in countries
- Also, it's not 5% and it comes with a high price tag – they can't bring it home without material additional U.S. taxes

	2011	2012	2013
Amazon	31.2%	78.6%	31.8%
Apple	24.2%	25.2%	26.2%
Google	21.0%	19.4%	15.7%
Starbucks	31.1%	32.8%	32.6%

Five Critical U.S. Tax Concepts

Current Taxation v. Deferral

- U.S. persons are taxed on a current basis on income from all sources worldwide. There is almost no preferential treatment of income earned abroad
- Foreign persons are taxed only on income from U.S. sources
- It follows that the principal planning opportunity for a U.S. person, whether a large multinational or a closely held business, is to form or acquire a foreign corporation that pays no U.S. tax on foreign operations. U.S. tax will not be paid until income is received by the U.S. person from the foreign corporation. This concept is known as "deferral"
- The United States seeks to counteract what it considers to be inappropriate deferral – the five concepts described below are critical to drawing the line and their application will help you answer the questions from the hypothetical clients discussed on slide 3

Critical U.S. Tax Concepts

- **Class and source of income** – All income must be classified and its source determined as U.S. or foreign
- **Entity classification** – Every business entity must be classified as a corporation or a partnership and as domestic (U.S.) or foreign
- **Foreign tax credits** – The United States allows a credit to its taxpayers for foreign taxes paid, but the credit is subject to limitations and special rules
- **Transfer pricing** – Transactions within a group must be priced as if group members were unrelated to each other
- **Anti-deferral rules** – A foreign corporation is not subject to U.S. tax on most non-U.S. source income but rules counteract use of foreign corporations to defer or avoid tax
  - The most important and relevant set of rules **are the "controlled foreign corporation" (CFC) rules** and the **"passive foreign investment company" (PFIC) rules**

Concept 1 – Class and Source of Income

- Income must first be classified. Important classes of income are interest, dividends, rents from tangible personal property or real property, royalties from intangible property, sales of personal or real property, and income from services
- Then the source of income must be determined according to a series of statutory rules
  - Interest: Interest paid by a domestic corporation or a non-corporate resident has a U.S. source; all other interest is foreign source
  - Dividend: Place of incorporation is determinative, but dividends from a foreign corporation will have a U.S. source if and to the extent the corporation has 25% or more of its gross income from a U.S. trade or business over a three-year period preceding the year of the dividend
  - Rents and royalties: Place the property located or used
  - Services, as employee or as independent contractor): Place where services are rendered (<u>not</u> location of employer or service recipient)
  - Sale of property: See next slide

Concept 1 – Source of Income from Sale of Property

- Real property: Location of the property is controlling
- Personal property
  - Tangible personal property – in general
  - Sales of inventory – title passage rule, with exceptions
  - Sales of depreciable personal property – where the depreciation was taken
  - IP – sale price computed like royalty sourced like a royalty
  - Sales through an office or fixed place of business
  - Sale of stock of affiliate
- Special definition of resident (U.S. corporation and noncorporate resident)
- Sale of partnership interest
  - Section 897(g) – Partnership holding U.S. real property – look through to underlying U.S. real property asset
  - Rev. Rul. 91-32 – Partnership engaged in U.S. trade or business – same look-through but without statutory authority

Concept 2 – Entity Classification

- The United States classifies every business entity as
  - A corporation – taxed as if it were a separate person – except that a U.S. corporation with U.S. individual shareholders (and certain trusts) can make an S election to be treated like a partnership; or
  - A partnership – not taxed (transparent); income flow to the partners or other owners who pay tax on their share of partnership income
  - If an entity would be classified as a partnership, but has only one owner, it is "disregarded" and its income and assets are treated as belonging directly to the owner
- In most cases, foreign limited company classified as follows:
  - By default as a corporation
  - But can elect ("check the box") to be classified as a partnership (two or more shareholders) or disregarded entity (one shareholder)
  - Exceptions where company will be treated as a corporation and no election is possible: China - Gufen Youxian Gongsi; Hong Kong and Singapore – PLC; Taiwan – Ku-fen Yu-hsien Kung-szu; U.K. and other jurisdictions – PLC; société anonyme in France, Switzerland (aka A.G.); Mexico – S.A. de CV

Concept 2 – Entity Classification: Domestic or Foreign

- Basic classification of a corporation or partnership as domestic or foreign is simple – the place of organization is controlling. See sections 7701(a)(4) and (5)
- However, there are several rules that can cause a foreign corporation to be treated like a domestic corporation:
  - The anti-inversion rules of section 7874
  - The stapled stock rule of section 269B
  - Elective rule for insurance companies – section 953(d)
  - Elective rule for treaty country holding U.S. real estate – section 897(i)
  - Elective rule to allow certain Canadian and Mexican corporations to be included in a consolidated group – section 1504(d)
- The anti-inversion rules in particular can interfere with structuring and restructuring of international operations

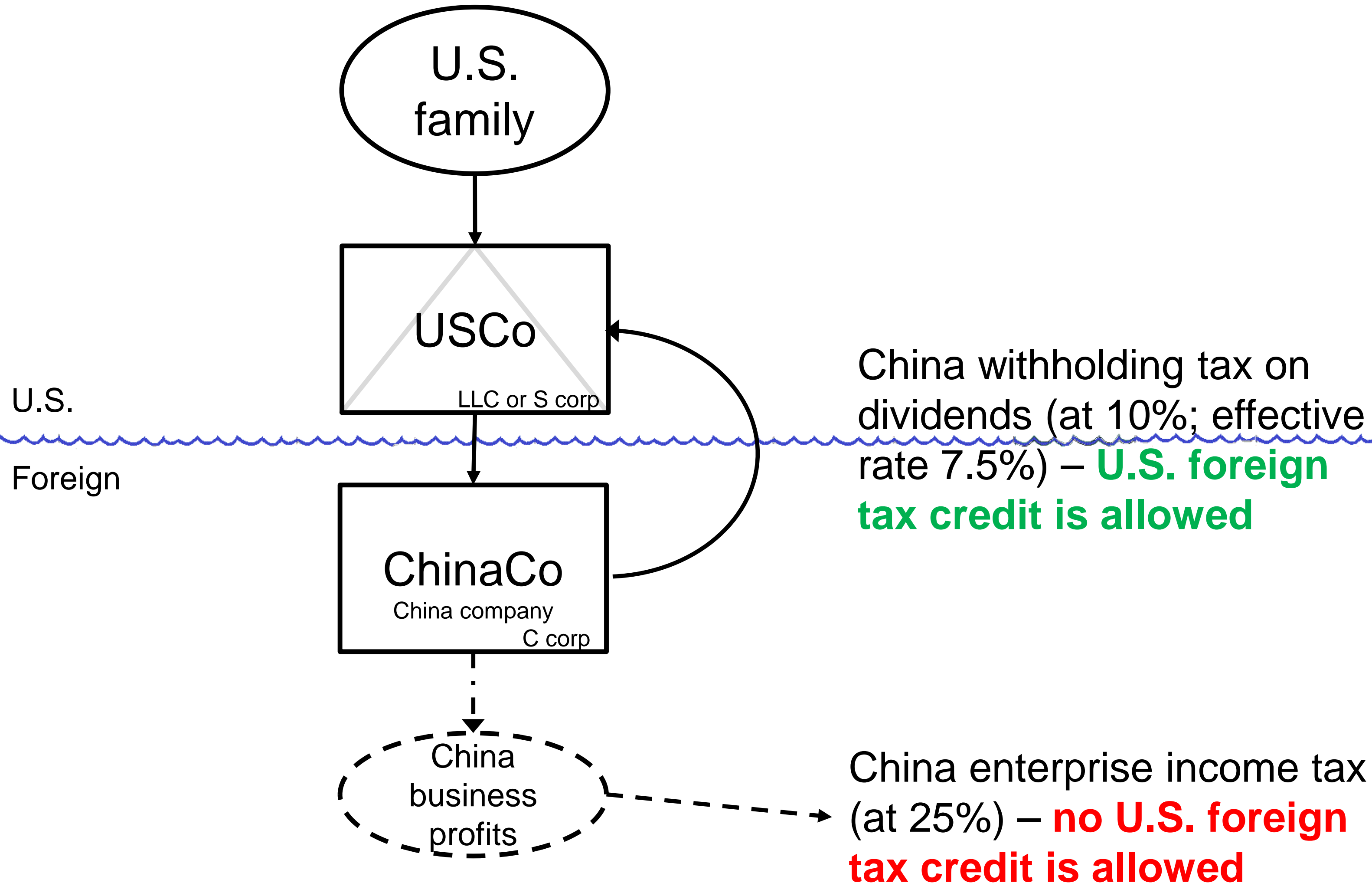
Concept 2 –Taxation of Corporations, Partnerships and Owners

- Partnerships do not pay tax. They compute their income and the partners or owners pay tax on their share, whether or not the partnership retains or distributes the income
- Corporations, as separate taxpayers pay tax.
  - Domestic corporations pay tax on worldwide income
  - Foreign corporations pay tax only on U.S.-related income
- The U.S. shareholders of corporations pay tax when
  - The corporation pays a dividend to them or they sell the shares
  - Earlier, or with additional taxes, if the corporation is a CFC or a PFIC (see Concept 5 below)
- Critically, if corporation is (a) domestic or (b) located in treaty country and certain qualifying conditions are met, individual U.S. shareholders may treat dividend as long-term capital gain – maximum rate currently 20%. Dividends from non-treaty countries and non-qualifying dividends are taxed as ordinary income – maximum rate up to 39.6%

Concept 3 – Foreign Tax Credits

- A country may impose tax based on
  - Place where the income is earned (“source-based taxation”)
  - Residence or citizenship of the taxpayer (“residence-based taxation”)
- As a result, both the source country and the country of residence may tax the same income
- To avoid double taxation, the United States allows its residents a credit for foreign tax on foreign source income
  - **Critically**, in the case of a U.S. individual, the credit applies to foreign tax paid directly or through a partnership or S corporation but <u>not</u> to tax paid by a foreign corporation owned by the individual (except for withholding tax on dividend – see next slide)
  - The credit cannot exceed U.S. income tax on foreign income – if, for example, foreign tax is $40 and U.S. tax is $35, the $5 excess can be carried over to a future year but cannot offset U.S. tax on U.S. income
  - Many states (but not California) allow individuals a deduction (29 states plus DC) or credit (16 states) for foreign tax. Of the 16, 5 allow the credit as the sole remedy and 11 as an alternative to a deduction

Concept 3 – U.S. Foreign Tax Credit



China withholding tax on dividends (at 10%; effective rate 7.5%) – **U.S. foreign tax credit is allowed**

China enterprise income tax (at 25%) – **no U.S. foreign tax credit is allowed**

Concept 4 – Transfer Pricing

- Transactions between members of a controlled group must be priced to meet the "arm's length" standard
  - This means the price that would be paid by uncontrolled parties
  - Pricing must be documented at the time of transactions
  - Taxpayer must maintain good records and documents concerning group transactions and pricing methods – independent economist studies may be needed to support pricing decisions
- Group transactions include:
  - Sales of goods and services
  - Group financing
  - Licenses and transfers of technology and other intellectual property
    - Note: Under U.S. transfer pricing rules, licenses and transfers of IP by USCo to ChinaCo must result in royalties or other payments to USCo "commensurate with income" earned by ChinaCo from exploiting IP
    - Where IP "baked into" products sold intercompany, it is nevertheless the product that must be priced – IP may affect the price but no separate royalty is required

Concept 5 – Controlled Foreign Corporations and Passive Foreign Investment Companies

- Foreign corporations do not pay U.S. tax unless they do business or invest in the United States
  - This is true even if all of the shareholders are U.S. persons
  - However, where foreign corporation has U.S. shareholders, those persons are subject to special rules, especially the CFC rules
- Foreign corporation controlled by five or fewer U.S. persons is known as a "controlled foreign corporation", or CFC
- Three major consequences of owning a CFC
  - CFC's "Subpart F income" is taxed to U.S. shareholders every year
  - CFC's other income is taxed to U.S. shareholders when:
    - Income is distributed as a dividend
    - U.S. shareholders sell the shares
    - CFC invests in U.S. assets – especially by lending to its U.S. shareholders
- What is Subpart F income?
  - Investment income – dividends, interest, rents and royalties
    - But numerous exceptions and special rules
  - Certain kinds of business income – see next slide

Concept 5 – Subpart F Income

- Investment income
  - Dividends, interest, rent and royalties
    - Some exceptions for inter-group payments – but often requires group members be in the same country (EU ≠ a single country)
    - But does not include “active rents” or “active royalties” – defined terms explained in more detail below
  - Gains from assets that produce dividends, interest, rents or royalties
- Certain income from sales of goods and services
  - “Foreign base company sales income”
    - CFC buys goods from related party or sells goods to related party; and
    - CFC did not manufacture or transform the goods
  - “Foreign base company services income”
    - CFC renders services outside its country of incorporation; and
    - Renders services on behalf of related company or with “substantial assistance” from U.S. shareholder or other U.S. person
- Also, if CFC invests its property in the United States (including making loans to U.S. shareholders), this may give rise to taxation under Subpart F rules – section 956

Concept 5 – PFICs

- PFIC taxation was supposed to level the playing field between domestic and offshore mutual funds
- However, definition of PFIC far broader than a foreign fund
  - Tax on PFIC distributions in excess of 125% of rolling three year average and gains on sale of PFIC subject to potentially punitive interest charge
  - PFIC dividends and QEF inclusions not eligible for qualifying dividend treatment
  - "Qualified electing fund" allows pass-through taxation of PFIC earnings but requires cooperation and information from PFIC
- For our purposes, the danger is that a foreign corporation that is not a CFC may unexpectedly turn out to be a PFIC
  - E.g., family-held real estate company with minority U.S. shareholder
  - Any 50:50 joint venture with a foreign partner risks being a PFIC if assets and income are not carefully monitored and managed

Don’t Forget State Taxes (Unless You’re in Wyoming)

- State treatment of foreign income varies broadly
- State treatment of deductibility and creditability of foreign taxes varies broadly
- Rules on CFCs vary - for example, California does not have any CFC or PFIC rules
- Where U.S. taxpayer is a C corporation, watch for the worldwide combination for unitary businesses and treatment of dividends from foreign corporations
- Ten states do not tax income of individuals at all, but some of those states (e.g., Florida and Texas) do have a tax on income of C corporations

Establishing an Outbound Business

Taxing Start-Ups

- The United States doesn't wait to start taxing international business until it is making profits
- The transfer of assets to a foreign corporation may trigger
  - Recognition of gain under section 367(a), notwithstanding the normal taxfree incorporation rules of section 351
  - Licensing income commensurate with income earned from intangibles – section 367(d)
  - Transfer pricing for goods and services provided to foreign subsidiary
  - Imputed interest under the below-market loan rules of section 7572
  - Application of the corporate inversion rules of section 7874, under which a foreign corporation may be re-classified as domestic
- Acquisition of a foreign corporation, especially one with potential Subpart F income or undistributed earnings, may also trigger unwelcome consequences
- These rules can all add expense to an international start-up and can impede efficient planning in the foreign country

Losses

- Any start-up may not be profitable to begin with and the start-up may incur losses
- Most of this presentation assumes that the ability to use start-up losses is not a key driver for the U.S. business expanding abroad, either because the business is expected to be profitable quickly or because the use of losses will effectively be deferred by the extensive U.S. requirements to capitalize expenditures in the start-up or construction phase of a business or project
- We do however comment below on some U.S. issues relating to losses that are created by the choice of structure

Modeling an Outbound Business

Structure Diagrams and Tax Models

- The following diagrams illustrate the tax treatment of various structures for an investment by a closely held business in a business in the People's Republic of China
- Preliminary - Assumptions
- Structures
  - Base Case
  - Base Case – with Check the Box Election
  - Base Case – Hong Kong Alternative 1
  - Base Case – Hong Kong Alternative 2
  - Treaty Holding Company
  - C Corporation Structure – Basic
  - C Corporation Structure – Treaty Holding Alternative
- Structures Summary

Assumptions

- The following diagrams present a stripped-down view of the structure
- No 3rd party interests – joint ventures are a whole other topic
- Unless otherwise stated on any slide, we will assume that:
  - USCo will earn all of the group's U.S. source income
  - ChinaCo will earn all of the group's non-U.S. source income
  - If there are transactions within the group, they will be priced at arm's length with guidance from an economist
  - Income from business operations will not be Subpart F income
- All tax is shown at the maximum statutory rate – we have ignored graduated rates. For example:
  - Federal rate of tax on ordinary income is shown as 39.6%
  - Affordable Care Act tax is shown at 3.8%
  - State income tax of 5% for both corporations and individuals. But note that for California, the top rate of personal income tax is 13.3% and the corporate rate is 8.84%

The Key Question: How Will Profits Be Used?

- The key to evaluating and choosing among the structures described below is how you expect to use the profits:
  - Fund capital needs in China
  - Expand outside China or make other non-China/non-U.S. business investments
  - Repatriate profits for investment in your U.S. business
  - Repatriate profits for distribution to individual shareholders
- All the structures result in broadly comparable tax on fully distributed profits
- But the expected use of the profits will determine the benefit of reducing China withholding tax on dividends and, more importantly, deferring U.S. taxation on the profits
- The taxpayer's objectives will drive which structure is best suited to those objectives

Base Case Structure

U.S. family

USCo

S corp or LLC

U.S.

Foreign

ChinaCo

China company

C corp.

Indicates flow-through entity for U.S. tax purposes, meaning the entity's income flows through to its owner

Base Case Structure – Tax Treatment

- USCo is an S corporation
  - The U.S. individual shareholders pay:
    - Ordinary income tax at up to 39.6%; 20% on dividends from ChinaCo
    - Affordable Care Act tax at 3.8%, except where income derives from USCo trade or business in which the shareholders "materially participate" (in which case they may pay 1.45% Medicare tax)
    - State personal income tax at assumed rate of 5%
- ChinaCo is a corporation resident in China
  - It pays enterprise income tax at 25% of its net income
  - It may be subject to various indirect taxes, e.g. VAT and Business Tax. We will treat the net cost of these taxes as a business expense and do not discuss them further
  - ChinaCo must withhold a 10% Chinese tax on dividends, interest and royalties paid to USCo
  - *Note: All descriptions of foreign tax laws should be confirmed by foreign country tax advisors*

Base Case Structure – Illustrative Computation

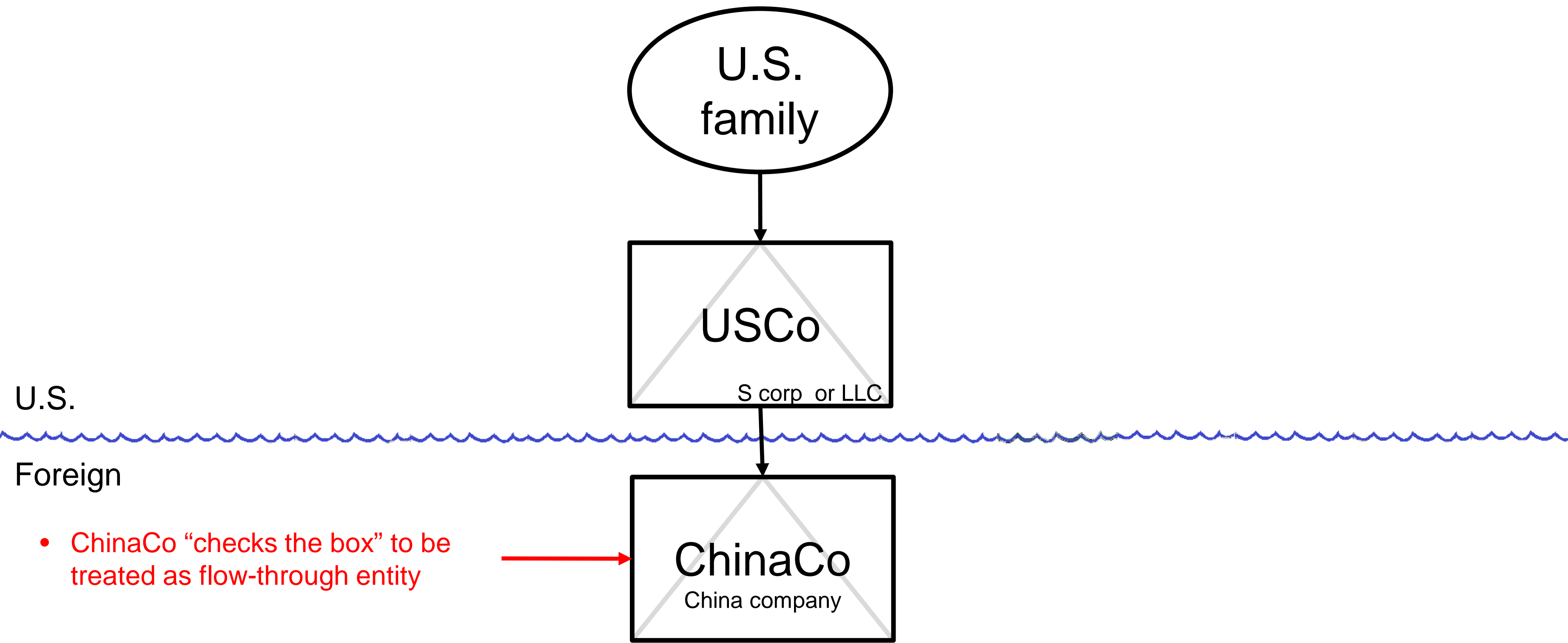
Time

Income earned

Income distributed from ChinaCo to USCo

	Rate		Tax
Income		1,000,000	
China corporate tax (effective rate)	25.0%	250,000	250,000
Net income		750,000	
China withholding tax	10.0%	75,000	75,000
Dividend (grossed up)		750,000	
Adjusted gross income (pre-state deduction)		750,000	
State income tax	5%	37,500	37,500
Federal taxable income		712,500	
Tax on dividend at long-term capital gain rate	20.0%	142,500	
Tax on ordinary income (pre-credit)			
Foreign tax credit (FTC)		(75,000)	
U.S. tax post-credit		67,500	67,500
Affordable Care Act tax	3.8%	27,075	27,075
Combined tax burden, with timing:			
Payable when income earned		250,000	
Payable when income distributed		207,075	
Total tax burden			**$457,075**

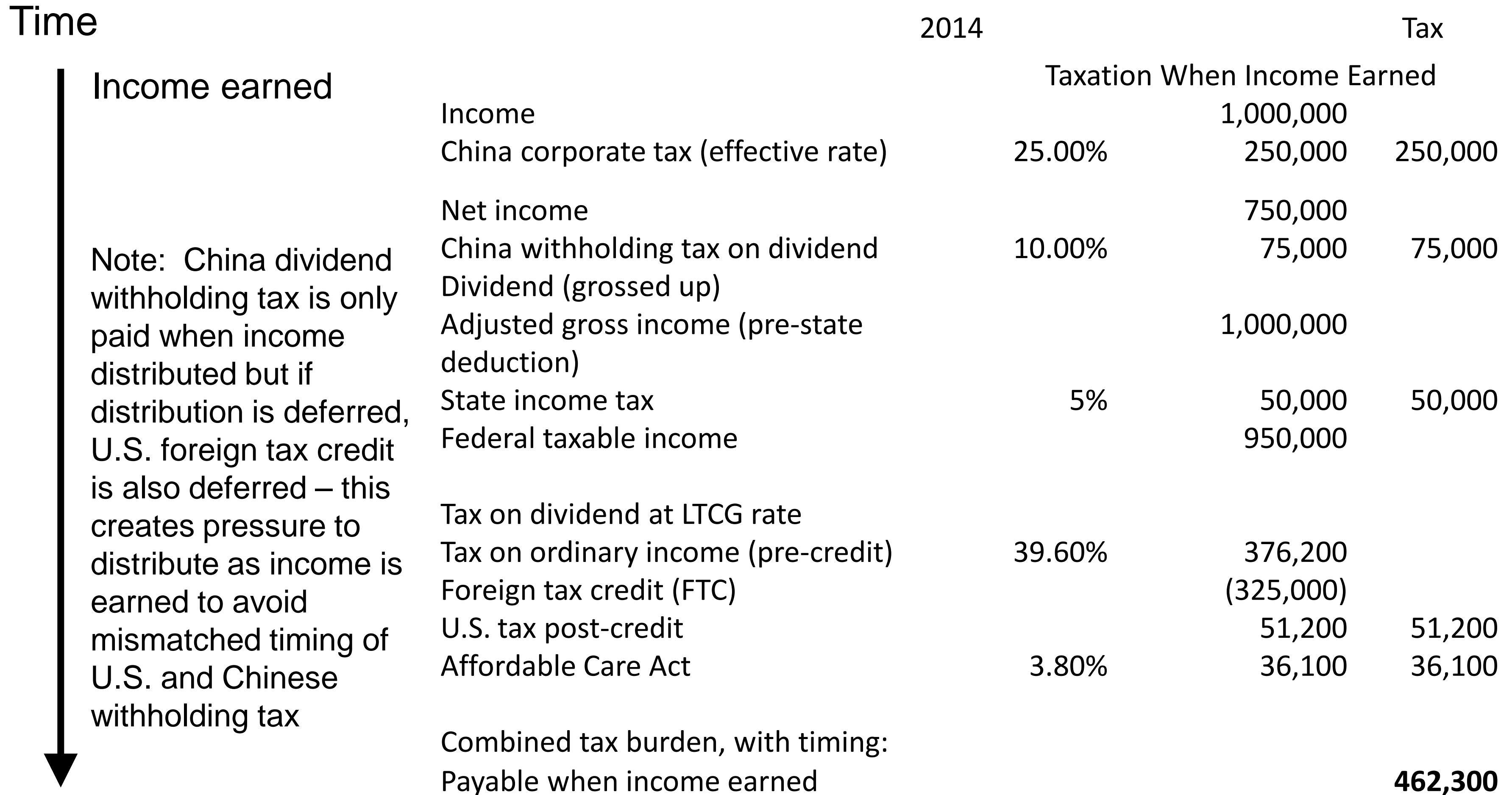
Base Case Structure – With Check the Box Election



- ChinaCo "checks the box" to be treated as flow-through entity

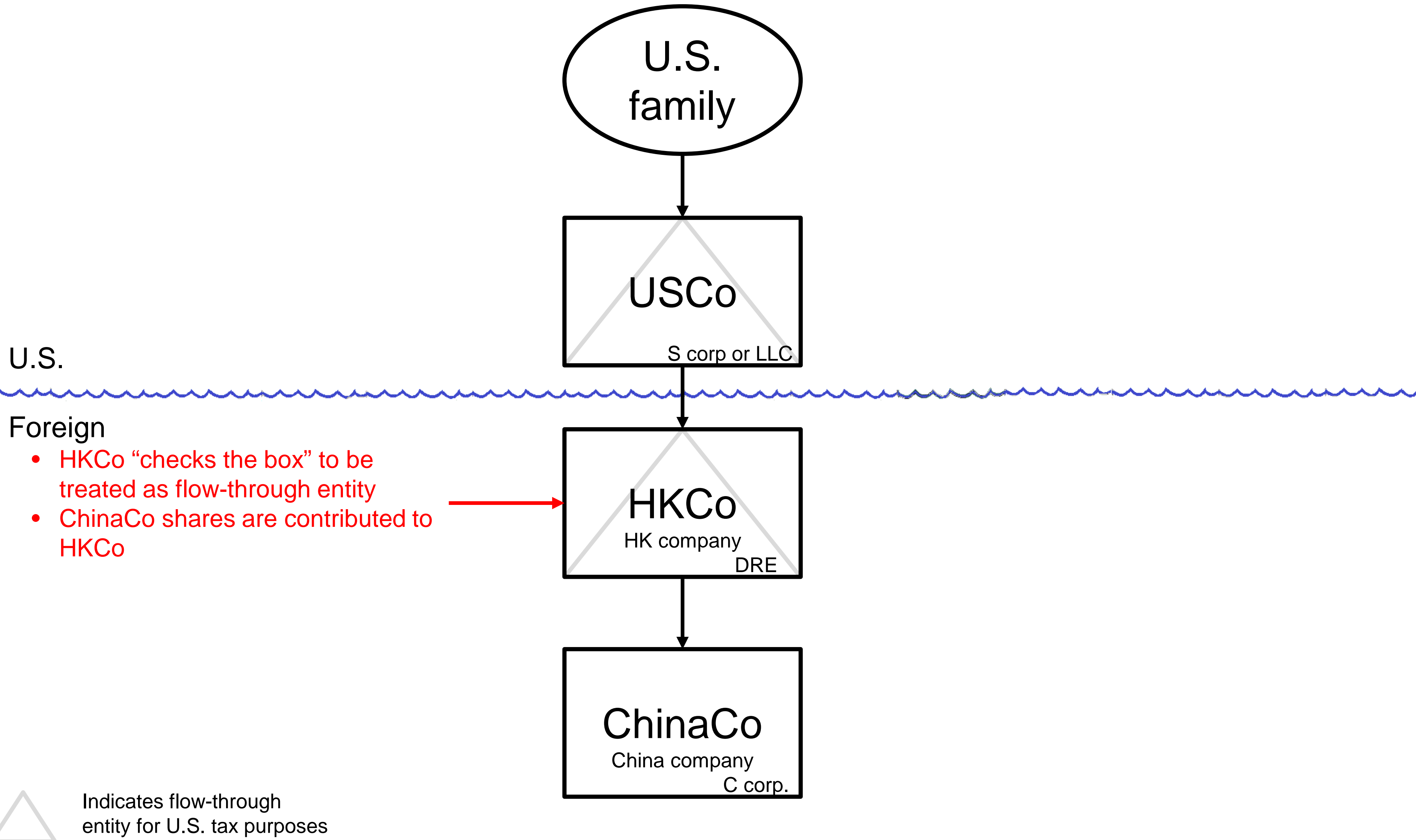
Indicates flow-through entity for U.S. tax purposes, meaning the entity's income flows through to its owner

Base Case Structure with Check the Box – Illustrative Computation



	2014		Tax
		Taxation When Income Earned	
Income		1,000,000	
China corporate tax (effective rate)	25.00%	250,000	250,000
Net income		750,000	
China withholding tax on dividend	10.00%	75,000	75,000
Dividend (grossed up)			
Adjusted gross income (pre-state deduction)		1,000,000	
State income tax	5%	50,000	50,000
Federal taxable income		950,000	
Tax on dividend at LTCG rate			
Tax on ordinary income (pre-credit)	39.60%	376,200	
Foreign tax credit (FTC)		(325,000)	
U.S. tax post-credit		51,200	51,200
Affordable Care Act	3.80%	36,100	36,100
Combined tax burden, with timing:			
Payable when income earned			**462,300**

Base Case Structure - HK Alternative 1



HK 1 Structure – Illustrative Computation

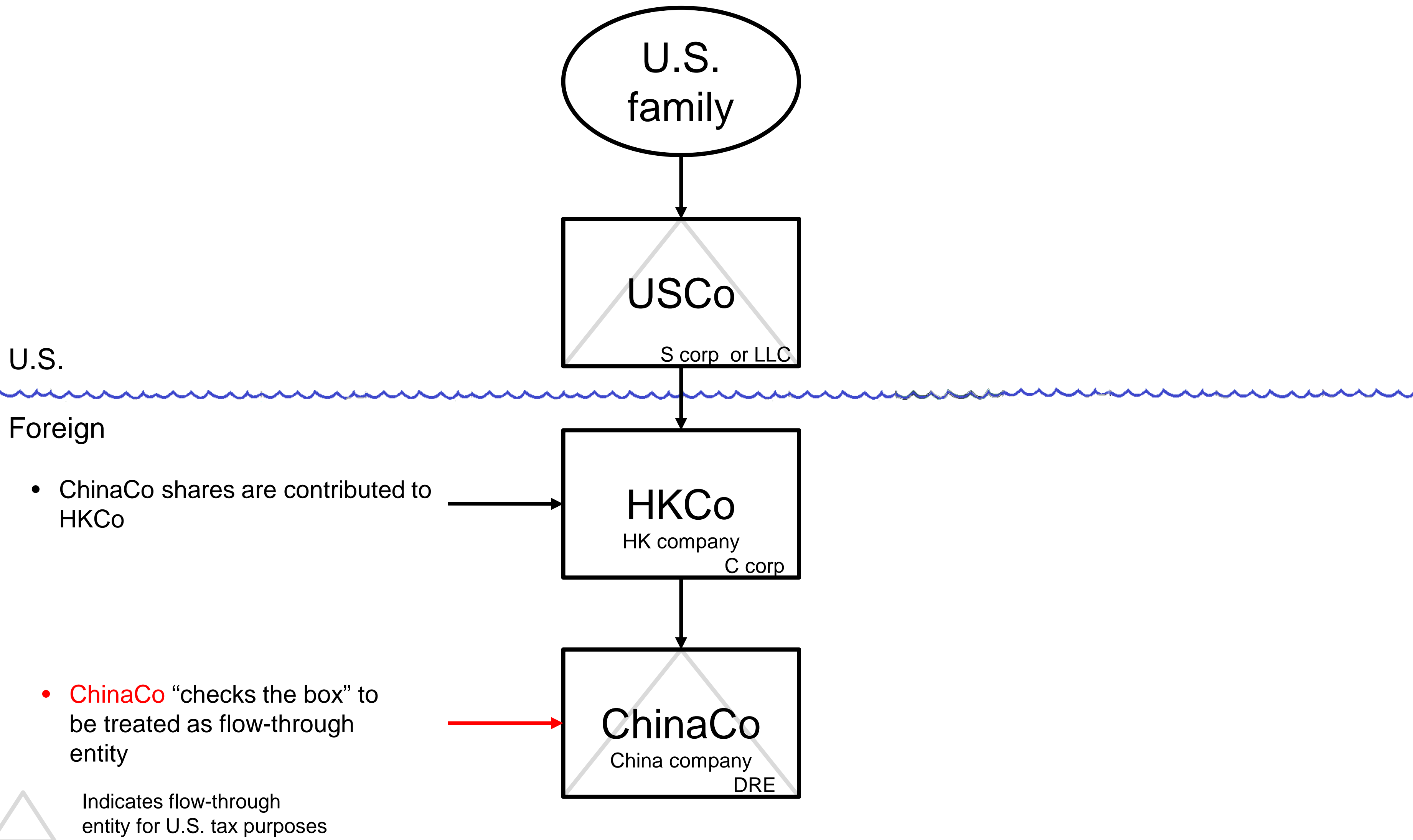
Time

		Rate		Tax
Income earned	Income		1,000,000	
	China corporate tax (effective rate)	25.0%	250,000	250,000
	Net income		750,000	
Income distributed from ChinaCo to USCo	China withholding tax	5.0%	37,500	37,500
	Dividend (grossed up)		750,000	
	Adjusted gross income (pre-state deduction)		750,000	
	State income tax	5.0%	37,500	37,500
	Federal taxable income		712,500	
	Tax on dividend at long-term capital gain rate	20.0%	142,500	
	Foreign tax credit (FTC)		(37,500)	
	U.S. tax post-credit		92,550	92,550
	Affordable Care Act tax	3.8%	27,075	27,075
				194,625
	Combined tax burden, with timing:			
	Payable when income earned		250,000	
	Payable when income distributed		194,625	
	Total tax burden			**$444,625**

Base Case Structure - HK Alternative 1

- The only difference with this structure is that Chinese withholding tax on dividends from ChinaCo to HKCo is reduced from 10% to 5% (and no tax is imposed by Hong Kong on dividends from HKCo to USCo)
- Since all of the withholding tax should be creditable for U.S. tax purposes, this results in:
  - No change to the overall tax burden
  - A slight difference in the timing and the place where tax is paid (decreased withholding tax payable to China when dividend paid; increased U.S. tax payable when estimated or final tax is due)
- However, this is worth considering because it reduces the risk of having excess foreign tax credits (meaning credits that may be lost or at best deferred)

Basic Structure – HK Alternative 2



HK 2 Structure – Illustrative Computation

Time		Rate		Tax
Income earned	Income		1,000,000	
	China corporate tax (effective rate)	25.0%	250,000	250,000
	Net income		750,000	
Income distributed from ChinaCo to HKCo	China withholding tax on dividend	5.0%	37,500	37,500
Income distributed from HKCo to USCo	Dividend (grossed up)		750,000	
	Adjusted gross income (pre-state deduction)		750,000	
	State income tax	5.0%	37,500	37,500
	Federal taxable income		712,500	
	Tax on dividend at ordinary rate (pre-foreign tax credit)	39.6%	282,150	
	Foreign tax credit (FTC)		(37,500)	
	U.S. tax post-credit		244,650	244,650
	Affordable Care Act tax	3.8%	27,075	27,075
				309,225
	Combined tax burden, with timing:			
	Payable when income earned		250,000	
	Payable when distributed to HKCo		37,500	
	Payable when income distributed to USCo		309,225	
	Total tax burden			$596,725

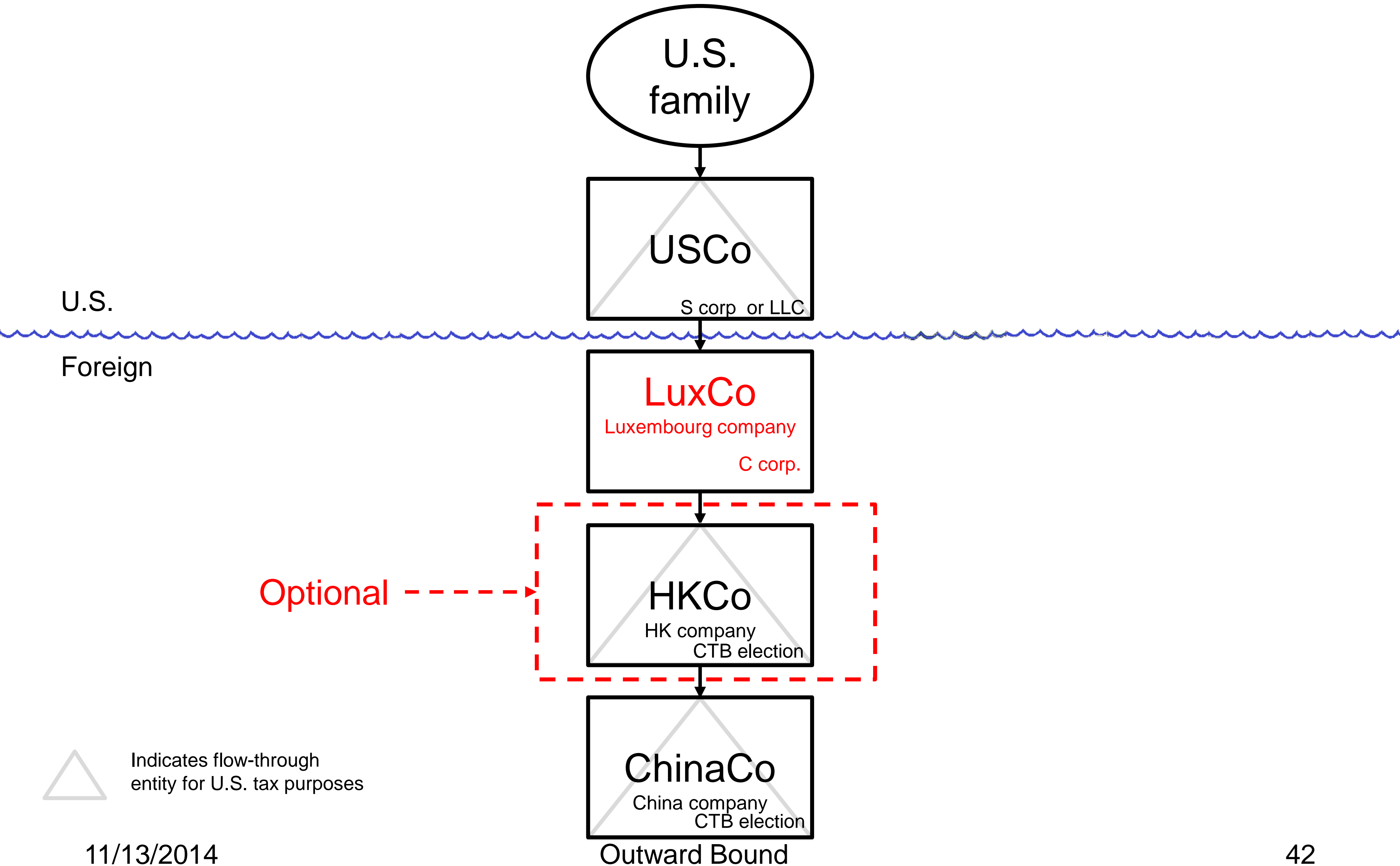
Base Case Structure - HK Alternative 2

- As with Alternative 1, under this structure Chinese withholding tax on dividends from ChinaCo to HKCo is reduced from 10% to 5% (and no tax is imposed by Hong Kong on dividends from HKCo to USCo)
- There is no U.S. tax when dividends are distributed from ChinaCo to HKCo, so that China profits can be redeployed outside the United States with no immediate tax
- However, because there is no U.S.-Hong Kong tax treaty, dividends will be taxed in the United States at 39.6%, nearly 20% higher than under the Base Case or Alternative 1
- The advantage of this structure is deferral of U.S. tax on profits earned in China until profits are repatriated to the United States, but without having to keep profits in China
- The disadvantage is the higher U.S. tax when the profits eventually do get repatriated

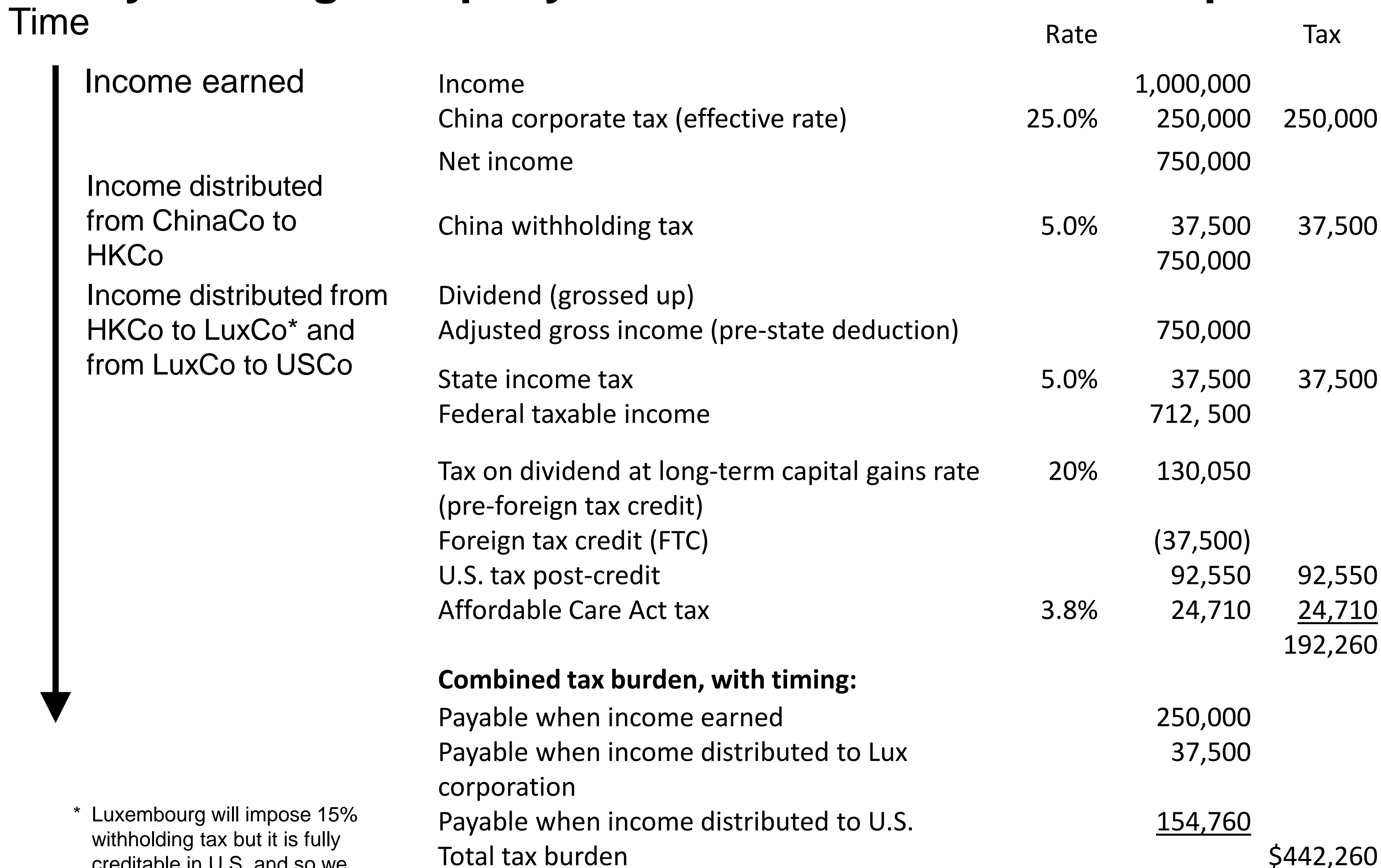
How's The Plan Coming On?

"Now this over here, this is why you're going to have to go to jail"

Treaty Holding Company Structure



Treaty Holding Company Structure – Illustrative Computation



Time

Time		Rate		Tax
Income earned	Income		1,000,000	
	China corporate tax (effective rate)	25.0%	250,000	250,000
	Net income		750,000	
Income distributed from ChinaCo to HKCo	China withholding tax	5.0%	37,500	37,500
			750,000	
Income distributed from HKCo to LuxCo* and from LuxCo to USCo	Dividend (grossed up)			
	Adjusted gross income (pre-state deduction)		750,000	
	State income tax	5.0%	37,500	37,500
	Federal taxable income		712, 500	
	Tax on dividend at long-term capital gains rate (pre-foreign tax credit)	20%	130,050	
	Foreign tax credit (FTC)		(37,500)	
	U.S. tax post-credit		92,550	92,550
	Affordable Care Act tax	3.8%	24,710	24,710
				192,260
	Combined tax burden, with timing:			
	Payable when income earned		250,000	
	Payable when income distributed to Lux corporation		37,500	
	Payable when income distributed to U.S.		154,760	
	Total tax burden			$442,260

* Luxembourg will impose 15% withholding tax but it is fully creditable in U.S. and so we have ignored it

Treaty Holding Company Structure

- This structure is designed to accomplish three things:
  - Chinese withholding tax on dividends from ChinaCo to HKCo or direct to LuxCo is reduced from 10% to 5%
    - HKCo optional, as China-Luxembourg treaty provides for 5% withholding
    - No tax imposed by Hong Kong on dividends from HKCo to LuxCo
  - No U.S. tax when dividends are distributed from ChinaCo to HKCo or LuxCo, so that China profits can be redeployed outside the United States with no immediate tax
  - When LuxCo pays dividend to USCo, U.S. rate of 20% applies
- This structure allows profits to leave China, without immediate repatriation to the United States. Because the United States has a treaty with Luxembourg (which it does not with Hong Kong), lower 20% rate is preserved on profits when eventually repatriated to U.S. – the best of both worlds
- Structure may require some substance in Luxembourg
- Alternatives to Luxembourg may include Belgium, the Netherlands, Switzerland and the United Kingdom

C Corporation Structure - Basic

U.S.
family

USCo
C corp.

U.S.

Foreign

ChinaCo
China company
C corp.

Indicates flow-through
entity for U.S. tax purposes

C Corporation Basic Structure – Illustrative Computation

Time

Time	Item	Rate		Tax
			Taxation When Income Earned	
Income earned	Income		1,000,000	
	China corporate tax (effective rate)	25.00%	250,000	250,000
	Net income		750,000	
			Taxation When Income Distributed to U.S. Corporation	
Income distributed from ChinaCo to USCo	China withholding tax	10%	75,000	75,000
	Dividend for state tax purposes		750,000	
	State income tax	5%	37,500	37,500
	Federal gross income		1,000,000	
	Deduction for California tax		37,500	
	Federal taxable income		962,500	
	Federal tax on U.S. corporation (pre-credit)	34.00%	327,250	
	Foreign tax credit (FTC)		(325,000)	
	U.S. tax post-credit		0	2,500
			Taxation When Income Distributed to U.S. Individual Shareholders	
Income distributed from USCo to USCo individual shareholders	Dividend		635,000	
	State income tax	5%	31,750	31,750
	Federal taxable income		603,250	
	Federal income tax at LTCG rate	20.0%	120,650	120,650
	Affordable Care Act	3.8%	18	24,130
			Combined tax burden, with timing	
	Payable when income earned			250,000
	Payable when income distributed to U.S. corporation			115,000
	Payable when income distributed to U.S. individual shareholders			168,910
	Total tax burden			533,910

* See note on next slide re Luxembourg withholding tax

C Corporation Structure – Basic

- In this structure, USCo either terminates S election or is replaced by a new C corporation
- This structure is designed to accomplish the following:
  - Allow repatriation of income to the United States to be used in USCo business at no immediate Federal income tax cost (additional Federal tax paid only when income further distributed to individual U.S. shareholders)
  - Substantially reduce tax uncertainty
- Overall tax cost is substantially lower until income is fully distributed to U.S. individual shareholders; it is higher once income is fully distributed

C Corporation Structure – Treaty Holding Alternative

U.S. family

USCo
C corp.

U.S.

Foreign

LuxCo
Luxembourg company
C corp.

ChinaCo
China company
CTB election

Indicates flow-through entity for U.S. tax purposes

C Corporation Structure (with Lux) – Illustrative Computation

Time

Income earned

Income distributed from ChinaCo to USCo

Income distributed from USCo to USCo individual shareholders

	Rate		Tax
	Taxation When Income Earned		
Income		1,000,000	
China corporate tax (effective rate)	25.00%	250,000	250,000
Net income		750,000	
	Taxation When Income Distributed to Luxembourg Corporation		
China withholding tax	5%	37,500	37,500
	Taxation When Income Distributed to U.S. C Corporation		
Dividend for state tax purposes		750,000	
State income tax	5%	37,500	37,500
Federal gross income		1,000,000	
Deduction for California tax		37,500	
Federal taxable income		962,500	
Federal tax on U.S. corporation (pre-credit)	34.00%	327,250	
Foreign tax credit (FTC)		(287,500)	
U.S. tax post-credit		39,750	39,750
	Taxation When Income Distributed to U.S. Individual Shareholders		
Dividend		635,250	
State income tax	5%	31,763	31,763
Federal taxable income		603,488	
Federal income tax at LTCG rate	20.00%	120,697	120,697
Affordable Care Act	3.80%		22,933
	Combined tax burden, with timing		
Payable when income earned			250,000
Payable when income distributed to Lux corporation			37,500
Payable when income distributed to U.S. corporation			77,250
Payable when income distributed to U.S. individual shareholders			175,393
Total tax burden			540,143

* See note on next slide re Luxembourg withholding tax

C Corporation Structure – Treaty Holding Alternative

- Main difference from basic C corporation structure is deferral of tax on dividend from China corporation until repatriated to the United States
  - Savings comes from reduced China withholding tax and deferral of California franchise tax
- Overall effective liability on profits fully distributed to individual shareholders is approximately the same as in the basic C corporation structure and the advantages and disadvantages are otherwise similar

Structures Summary

Structure ➔	Base Case	Base Case (with ChinaCo Check the Box Election)	Basic Structure – HK Alternative 1	Basic Structure – HK Alternative 2	Treaty Holding Company Structure	C Corporation Structure	C Corporation (with Treaty Holding Company)
Timing ➔	Slides 30-32	Slides 33-34	Slides 35-37	Slides 38-40	Slides 42-44	Slides 45-47	Slides 48-50
	Tax rate refers to the combined effective rate of all taxes at the time indicated in column 1						
Income earned	25.00%	51.78%*	25.00%	25.00%	25.00%	25.00%	25.00%
Income distributed from ChinaCo to HKCo or treaty company	N/A	* See note on slide 8 re timing issue	19.46%	3.75%	3.75%		3.75%
Income distributed to USCo	20.71%			30.92%	15.48%	11.50%	7.73%
Income distributed to shareholders						16.89%	17.54%
Total on fully distributed income	45.71%	46.23%	44.46%	59.67%	44.23%	53.39%	54.01%

See tax rate assumptions on slide 28

Additional Comments

- As the summary demonstrates, there is no structure that does not have a high overall effective rate on fully distributed profits
- The key is to determine where you want the profits deployed before they are fully distributed to the shareholders
  - Reinvest in China – base case structure is fine
  - Reinvest outside China but not in the United States
    - Treaty company structure works well but is more expensive to operate
    - Hong Kong alternative 2 less expensive but much higher eventual tax
  - Reinvest in the United States - C corporation works well but higher overall tax when profits eventually distributed to shareholders
  - Fully distribute to shareholders – base case structure is best
- Profits attributable to intellectual property require additional planning, to which we now turn

Issued Relating to Losses

- No flow-through of losses from foreign entity unless the entity is classified as a partnership or disregarded entity
- If losses do flow through, and reduce U.S. source profits, then when profits eventually flow through, the profits will be reclassified with a U.S. source and will therefore reduce the availability of foreign tax credits under the overall foreign loss rules

Planning for Intellectual Property

Planning for Intellectual Property

- In many cases, the business opportunity for closely held businesses will result from significant intellectual property
- That IP may be in the form of a patent for an innovative product or process; a copyright for an app, a game, a film or a compilation of valuable data; a trademark in a hot new product or service; or technical knowhow
- The U.S. tax system seeks to impose a current tax on profits earned abroad from IP originated by U.S. businesses
- Tax planning for IP-related profits must navigate these rules – it's a highly complex area which brings to bear all of the concepts we identified at the beginning of this presentation
- The rules are **not** dumbed down for small business – they apply in all their sophistication and ferocity to start-ups and small business as they do to large multinationals

What follows is a brief effort to identify some key issues

Key U.S. IP Tax Issues

- Classification and therefore sourcing of IP-related income:
  - Is income derived from tangible or intangible property?
  - Is income derived from sale or license of property?
  - Is income derived from performances of services?
- If a U.S. person transfers or licenses IP to a related foreign corporation, current income recognized "commensurate with the income attributable to the intangible". This applies to
  - A sale or license of IP – section 482 (the basic transfer pricing rule)
  - A contribution of IP to the capital of a corporation – section 367(d)
- Income earned by foreign corporation from exploitation of IP may be Subpart F income:
  - Foreign personal holding company income, which includes royalties, unless derived from active conduct of a trade or business
  - Foreign base company sales income, which includes income from certain sales of patented or copyrighted products purchased from or sold to related parties

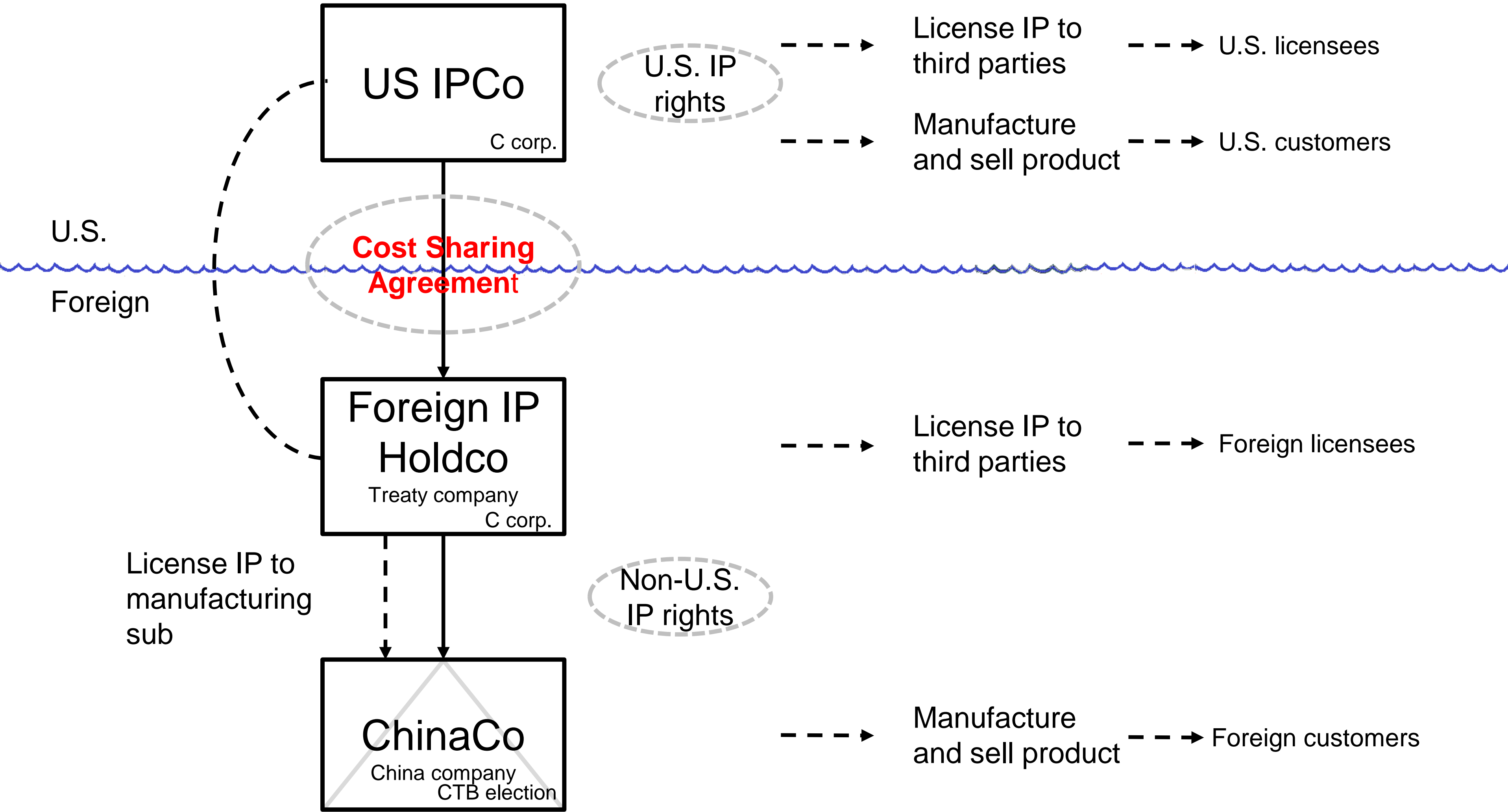
IP Planning

- Objective: Transfer IP that will be further developed and then used outside the United States to a foreign corporation that will exploit the IP without payment of U.S. tax before profits are repatriated
- Obstacles:
  - The commensurate with income rules
  - Transfer pricing rules
  - Subpart F classification of the income
  - Foreign corporation must not be engaged in a trade or business in the United States
- A cost sharing agreement (known in Europe as a cost contribution arrangement) is a device to deal with the first of these two obstacles

Cost Sharing Agreement – Basics

- The basic idea is that a U.S. corporation and its foreign affiliate will share the costs of developing the IP and each will own the rights to IP in defined territories
  - Costs shared based on reasonably anticipated benefits
  - If the agreement meets the requirements for a "qualified cost sharing agreement", section 367(d) does not apply and only costs can be re-allocated, not income or profits
- If U.S. person has already developed some IP when cost sharing agreement entered into:
  - Developer must be compensated based on a valuation of "platform contributions", typically through a royalty – this is known as the buy-in
  - The earlier in the process the cost sharing agreement is entered into, the lower the buy-in to the U.S. developer
  - Buy-in subject to look-back adjustments based on actual v projected benefits
  - Economist required to give opinion on buy-in valuation

Typical Cost Sharing Agreement Structure



Subpart F Considerations – Licensing Income

- If the foreign corporation is engaged in licensing its non-U.S. IP rights to third parties, its royalty income will be Subpart F income unless the royalties are derived from the "active conduct of a trade or business"
- Under Reg. § 1.954-2(d), CFC must derive royalties either:
  - From licensing property that CFC
    - has developed, created, or produced or
    - has acquired and to which it has added substantial value

    but only so long as CFC is regularly engaged in the same kinds of activities
  - From licensing resulting from the performance of marketing functions CFC, <u>through its own officers or employees located in a foreign country</u>, maintains and operates an organization in such country that:
    - Is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and
    - Is substantial in relation to the amount of royalties derived from the licensing of such property
- Active rents from real and personal property similarly defined

U.S. Trade or Business Considerations

- The foreign corporation that holds the IP should not be engaged in a U.S. trade or business
- If it is so engaged:
  - It may be taxable even on certain classes of foreign source income, including royalties and sales of inventory
  - U.S. source income may also be subject to branch profits tax
- This requires that the foreign corporation have real business activity outside the United States, including an office or fixed place of business which materially participates in the earning of foreign source income

Final Thought

"We've been at it for the better part of an hour and still no solution."

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We are now Circular 230 Disclaimer Free

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