BASICS OF US INTERNATIONAL TAXATION — OUTBOUND

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This white paper summarizes basic elements of US international income taxation, with an emphasis on the rules that apply to US persons doing business or investing in foreign countries (i.e., outbound issues).[1]

This white paper is intended for general information purposes only. It is not intended as legal, tax, or financial advice. The reader is urged to consult a qualified advisor before making any decisions relating to the matters discussed in this white paper.

[1] This discussion of US income tax matters is based on existing law as contained in the Internal Revenue Code of 1986, as amended (the "Code"), treasury regulations, administrative rulings, and court decisions as of the date of this memorandum. Future changes to the law may, on either a prospective or retroactive basis, give rise to materially different tax consequence. This white paper does not consider or discuss the impact of various proposals to amend the Code or other tax authorities that could change certain of the matters described in this white paper.

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"US Person"

In general, a "US person" includes (1) a citizen or resident of the US, (2) a partnership or corporation created or organized in the US, and (3) estates and trusts administered in the US.[2]

US persons are subject to US income tax on their worldwide income. However, except as described below (see Certain Anti-Deferral Rules), when a US person owns a foreign corporation, the income earned by that foreign corporation is not subject to US taxes until repatriated to the owner in the form of a dividend.

CLASSIFICATION OF FOREIGN ENTITIES

Foreign entities with more than one owner are classified as "corporations" or "partnerships" for US tax purposes. Typically, the entity will be considered a corporation if none of the owners is liable for the entity's obligations. However, it is often possible to "check the box" and elect whether the foreign entity will be classified as a corporation or partnership for US tax purposes.

The US tax consequences will vary dramatically based on whether a foreign entity is classified as a partnership or a corporation, as summarized below.

FOREIGN PARTNERSHIP CLASSIFICATION

If the foreign entity is considered a partnership for US tax purposes, the US partners will be required to report their share of the foreign entity's income, gain, loss, deduction, credit, and other tax items on a pass-through basis. Each of the US partners will be taxed in the US based on this share of tax items, regardless of whether a distribution from the foreign entity has been made. In addition, the US partners will generally be entitled to a foreign tax credit for their share of foreign income taxes paid by the foreign entity.[3]

Furthermore, as is the case with a domestic partnership, US income taxes will apply only once – to the partners as income is earned by the foreign entities. There generally would not be a second level of US income tax when the earnings are distributed to the partners.

This pass-through tax system suggests that in foreign countries where the local effective tax rates applicable to the foreign entities are greater than or equal to the effective US tax rates,

[2] Specifically, (i) an estate the income of which is subject to US federal income taxation regardless of its source, and (ii) a trust if (A) it is subject to the primary supervision of a court within the US and one or more US persons have the authority to control all substantive decisions of the trust, or (B) it has a valid election in effect under applicable US Treasury regulations to be treated as a US person.

[3] The US foreign tax credit does not always perfectly offset foreign taxes paid. For example, the credit is limited to the amount of US tax due with respect to net foreign source income within various foreign tax credit limitation categories, and the dollar amount of the credit is determined in accordance with US currency translation rules. Similarly, US law applies to determine carryover periods for excess credits and other inter-year adjustments. In addition, a foreign tax credit generally is not available to reduce state income taxes.

In foreign countries where the local effective tax rates applicable to the foreign entities are greater than or equal to the effective US tax rates, it will often be advisable to conduct business through an entity that is treated as a foreign partnership for US tax purposes.

it will often be advisable to conduct business through an entity that is treated as a foreign partnership for US tax purposes. In that case, the US partners would report their share of the foreign entity's tax items and would pay US taxes (with a credit for foreign taxes paid) as the income is earned, and generally would not be subject to additional US taxes when distributions are made.[4]

FOREIGN CORPORATION CLASSIFICATION

On the other hand, if the foreign entity is a foreign corporation, except under various "anti-deferral" provisions (mentioned below), the foreign entity's income from sources outside of the US generally are not subject to tax in the US until that income is repatriated to the US owner in the form of a dividend. This tax-deferred income can generally be reinvested in foreign businesses without imposition of US income tax.

Therefore, from a US tax perspective, conducting business through a foreign corporation will be beneficial in situations where the effective foreign tax rates are significantly lower than the US tax rates and where there is expected to be a benefit to reinvesting the income without incurring US taxes. This is especially true when the foreign dividend will be treated as a "qualified dividend" for US tax purposes when repatriated (see **Qualified Dividend Rules** below).

CERTAIN ANTI-DEFERRAL RULES

As mentioned above, under various "anti-deferral" provisions of the Code, US persons may be required to (i) recognize taxable income prior to their receipt of distributable proceeds, (ii) pay an interest charge on tax liability deemed as having been deferred, or (iii) recognize ordinary income that, but for the "anti-deferral" provisions, would have been treated as capital gain. Although these anti-deferral rules can be quite complicated, the following discussion touches on the principal aspects of these rules.

[4] The US foreign tax credit is generally available only with respect to foreign income taxes or taxes imposed in lieu of foreign income taxes. Property taxes, VAT, and other taxes that are not regarded as income taxes generally do not qualify.

US shareholders of a CFC must include "Subpart F income" earned by the CFC in their gross income for US tax purposes regardless of whether that Subpart F income has been distributed.

1 Controlled Foreign Corporations, Subpart F

Under Subpart F of the Code, US persons who are direct or indirect shareholders of a "controlled foreign corporation" ("CFC") are subject to enhanced US federal income tax obligations. A foreign corporation is a CFC if "US shareholders" own more than 50% of the total voting power or more than 50% of the total value. A US shareholder is any US person (including a domestic partnership) with a 10% or greater voting interest in the foreign corporation.

US shareholders of a CFC must include "Subpart F income" earned by the CFC in their gross income for US tax purposes regardless of whether that Subpart F income has been distributed. This is because the Subpart F income is deemed to be a dividend paid by the CFC to its US shareholders, even when the US shareholders have not received any such dividend.

Although the determination of Subpart F income can be very complex, Subpart F income generally includes passive income earned by the CFC (i.e., interest, dividends, rents, and royalties) as well as certain income from active business operations where a related party in the supply chain has activities occurring outside of the CFC's country of organization. Income inclusions under Subpart F also include investments in US property made by the CFC, illegal bribes and kickbacks paid by the CFC, and certain other sources of income and investment. Subpart F income can also be generated by doing business in boycotted or blacklisted countries, which include Cuba, Lebanon, Libya, North Korea, Sudan, Syria, and others.

Subpart F also accelerates tax on CFC earnings that are invested in US property. (Without this rule, it could be possible to effectively repatriate the CFC's earnings without paying US tax.) For example, loans made by a CFC to a US shareholder or related US person would generate Subpart F income. Similarly, guarantees by CFCs of loans to a US shareholder or related US person can also generate Subpart F income. Any transactions of this nature need to be monitored and analyzed on a case-by-case basis.

Finally, when a US person disposes of stock of a CFC, special rules may cause that disposition to give rise to ordinary income treatment (as a deemed dividend) rather than capital gain treatment. The IRS has ruled that this deemed dividend may be a "qualified dividend" eligible for preferential capital gains rates, to the extent that the qualified dividend rules apply to the CFC.

2 Passive Foreign Investment Companies

In addition, a foreign corporation may be treated for US income tax purposes as a "passive foreign investment company" ("PFIC"). Direct or indirect ownership of a PFIC's shares may cause certain unfavorable federal income tax consequences, such as a deemed interest charge and the recharacterization of capital gains from the disposition of PFIC stock as ordinary income. In some cases, it is possible to make US tax elections that ameliorate some of these consequences with respect to PFIC investments.

A PFIC is a foreign corporation where either (i) 75% or more of its gross income is passive income, or (ii) the average percentage

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of its assets that produce passive income or that are held for the production of passive income is at least 50%. Designation as a PFIC is generally permanent, unless certain steps are taken. Classic examples of PFICs include foreign mutual funds, foreign hedge funds, and other similar foreign pooled-investment arrangements. However, any foreign corporation can be a PFIC if it otherwise satisfies the test described above.

The concept of "passive income" for PFIC purposes is defined by reference to the CFC rules mentioned above. However, to the extent that interest, dividends, rents, and royalties from related persons are allocable to non-passive income of the related person, they are not "passive." Furthermore, a foreign corporation looks through to the underlying activities of any other corporation where it owns at least 25% (by value) of such entity.

The CFC rules take precedence over the PFIC rules. Thus, if an entity is a CFC, the US shareholders of that CFC generally are not also treated as owners of a PFIC.

QUALIFIED DIVIDEND RULES

The Code generally provides that "qualified dividend income" is taxed as long-term capital gains. Qualified dividend income includes dividends received from domestic corporations and from qualified foreign corporations. In addition to certain publicly traded corporations, "qualified foreign corporations" include corporations that are eligible for benefits under a comprehensive income tax treaty with the US if the IRS determines that the tax treaty otherwise qualifies.

Dividends from PFICs are "qualified" dividends for this purpose.

The qualified dividend rules benefit shareholders who are natural persons, trusts, or estates. The rules also apply to dividend income that is received by pass-through entities (i.e., partnerships and S corporations) and allocated to owners of the pass-through entities who are natural persons, trusts, or estates. However, a corporate taxpayer will not derive these benefits from qualified dividend income.

As mentioned above, Subpart F income is included currently in the income of the US shareholders as a deemed dividend, regardless of whether the US shareholders have received a distribution. Subpart F income is taxed as ordinary income. It is not taxed again when actually distributed to the US shareholders.

Income of a CFC that is not Subpart F income is not subject to US tax in the hands of the US shareholders until distributions are made to shareholders. The IRS accepts that these normal distributions from CFCs can be qualified dividends, provided that the other requirements (mentioned above) are met. Likewise, capital gain from the sale of CFC stock that is recharacterized as dividend income can be treated as qualified dividend income.

On the other hand, the IRS position is that Subpart F inclusions cannot be qualified dividends. Therefore, not only is Subpart F income taxed currently under the CFC rules, it is taxed at full ordinary income rates and not at the favorable rates afforded to qualified dividend income.

HOLDING COMPANIES

Multinational businesses are typically conducted through many affiliated legal entities, often owned through some type of holding company structure.

Middle-market businesses ... will need to review their intercompany relationships and pricing structures to ensure that they are compliant with applicable tax rules.

Holding company structures can be beneficial for several reasons, including centralization of management and finance functions, consolidation for financial reporting purposes, enhanced access to capital, the ability to more easily provide equity compensation to management and other key employees, the isolation of liabilities, and permitting local ownership of subsidiaries to the extent necessitated by business conditions or local law. Establishing a holding company structure may also provide certain tax benefits, such as reducing worldwide effective tax rates, providing an efficient tax reporting function, and permitting more flexibility in transferring corporate assets among entities and/or locations.

WITHHOLDING RULES

The Code requires withholding of US taxes in several situations. One category of withholding rules requires withholding of US taxes at a flat 30% rate by the payor of any so-called fixed, determinable, annual, or periodic ("FDAP") income from US sources. Among other things, FDAP includes interest, dividends, rent, royalties, and wages from US sources.

There are several exceptions to US withholding on FDAP, including when the FDAP is considered "portfolio interest" or is interest from bank deposits. These exceptions from withholding on US source interest are quite broad and often result in no US tax on interest paid to non-US investors. Furthermore, income that is derived from a US trade or business is not FDAP, although it is typically taxable in the US under the same self-assessed graduated rate structure that applies to US businesses. In addition, proceeds from the sale of capital assets typically are not considered FDAP.

When a US person makes payments to a non-US person, Form W-8 should be collected from the payee to ensure that appropriate withholding is made. If withholding with respect to FDAP is necessary, the payor typically files Form 1042 to report the interest and withholdings to the IRS, and the payee typically is not required to directly report its US taxes.

Withholding can be significantly reduced or eliminated under income tax treaties (see **Tax Treaties**).

TAX TREATIES

The US is party to nearly 70 income tax treaties with foreign countries. There are additional tax treaties relating to estate and gift tax, information sharing, and other tax-related subjects.

Under the income tax treaties, residents of the US and the treaty country are generally taxed at reduced rates, or are exempt from tax, on certain items of income they receive from sources in the other country. These reduced rates and exemptions vary among countries and specific items of income (interest, dividends, royalties, etc.).

Income tax treaties also contain rules for determining the residency of taxpayers, avoiding double taxes, sharing information by the taxing authorities of each country, and resolving inconsistencies under the relevant countries' laws with respect to the characterization of income earned by a taxpayer.

If the treaty does not cover a particular kind of income, or if there is no treaty between the relevant countries, then the default tax rules of each country will apply.

To ensure that cross-border transactions are structured appropriately, the application of income tax treaties must be considered.

TRANSFER PRICING AND ADVANCED PRICING AGREEMENTS

Transfer pricing refers to the price at which affiliated companies transfer goods and services among themselves. When affiliates are located in different taxing jurisdictions, or have different tax attributes, there is opportunity to set prices in a way that will result in lower combined effective tax rates. Not surprisingly, transfer pricing is a high-priority issue for tax authorities around the world.

For US tax purposes, goods and services provided from one affiliate to another must be conveyed at an "arm's length" price. Although there are several methods for establishing the price, the general principle is that the terms of sale should reflect an open market transaction between unrelated buyers and sellers.

Although US transfer pricing initiatives have historically focused on large multinational enterprises, the IRS has been expanding its initiative into the middle market. Specifically, the IRS has been stepping-up its transfer pricing efforts with respect to taxpayers with assets of $10 million to $250 million. In this regard, the IRS has been hiring and training additional staff for transfer pricing audits. It has also invested in developing additional enforcement tools, such as enhanced information reporting and more transparent exchange of information.

Middle-market businesses, which may have historically been "under the radar" with respect to transfer pricing issues, will need to review their intercompany relationships and pricing structures to ensure that they are compliant with applicable tax rules.

Advance pricing agreements ("APAs") can help protect taxpayers with international activity from double taxation. An APA is an agreement between the IRS and a taxpayer as to appropriate transfer pricing of goods and services among a taxpayer and its affiliates. An APA can also be multilateral, involving the US and another country, to ensure consistent pricing for the taxpayer and its affiliates in the US and the other country. Taxpayers with transfer pricing concerns should consider the use of APAs where appropriate to help reduce the risks associated with transfer pricing audits.

US INFORMATION REPORTING

US income tax laws include significant information-reporting requirements for US persons with direct or indirect investments in foreign entities. Some of the common informational reporting forms are:

- Form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations, requires reporting of balance sheet and income statement information for each foreign corporation for which the US person holds 10% or more of the vote or value of the stock of the foreign corporation.

- Form 926, Return by a US Transferor of Property to a Foreign Corporation, requires reporting of certain transfers of tangible or intangible property to a foreign corporation.

- Form 8865, Return of US Persons with Respect to Certain Foreign Partnerships, requires reporting of similar information to Form 5471 for a US resident that owns at least 10% of the interest in a foreign partnership.

- Form 8858, Information Return of US Persons with Respect to Foreign Disregarded Entities, requires reporting of similar information to Form 5471 and Form 8865 for US-resident owners of foreign disregarded entities.

- Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, requires reporting of all PFIC interests held by the US person.

- Form 3520, Annual Return to Report Transactions with Foreign Trusts and to Report Receipt of Foreign Gifts, requires reporting of contributions to and receipt of distributions from foreign trusts.

- Form 3520-A, Annual Information Return of Foreign Trust with a US Owner, requires balance sheet and income statement information of a foreign grantor trust.

- Form 8938, Statement of Foreign Financial Assets, requires reporting of foreign financial assets.

- FBAR (FinCEN 114 – formerly TDF 90-22.1), Report of Foreign Bank and Financial Accounts, requires reporting of all foreign financial accounts in which a US person has a financial interest or signatory authority.

This white paper is intended to provide a basic overview of many of the US income tax issues relevant to outbound transactions. Although we intend to provide an accurate summary, please remember that this white paper is naturally limited in scope, and should not be relied upon without specific legal and tax advice.

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