



# Foreign filings: Navigating international tax\*

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Efficient global operations require an understanding of international taxes as well as an awareness of legislative changes proposed by the Obama Administration.

When US private companies start operating offshore, they're often not aware of international tax provisions. "They're used to dealing with US tax structures, so they think the world operates like the United States," said Thomas Guaraldo, a partner with PricewaterhouseCoopers' International Tax Services group.

But there is an important difference. Whereas most foreign countries collect taxes only on income earned within their borders, the United States taxes its citizens' income worldwide. "If you're a US individual or corporation, you pay US income taxes on your income no matter where you're located or where the income was earned," said David Gilbertson, international tax director with PwC. "The only question is when you pay: in the year it was earned or when it's repatriated to the United States."

An international tax strategy begins with choosing what type of business entity to use. If a US company operates as a pass-through entity

(meaning a partnership, LLC, or S corporation), US income taxes on its earnings are "passed through" to its owners, who pay them on their annual tax returns. If the business operates as a corporation, the corporation pays income taxes initially on earnings, while its shareholders pay a separate tax on those earnings when they are redistributed as dividends—in effect, a form of double taxation.

Depending on their earnings and transactions, it may be advantageous for US corporations operating offshore to set up a separate foreign entity to conduct business overseas. If a US corporation operates offshore as a foreign corporation and reinvests its foreign earnings offshore, then the US income tax is deferred until the income is repatriated in the form of a dividend or is deemed repatriated under antideferral regimes (explained later). Also, a US corporation (with the exception of a Subchapter S corporation) can claim a credit for foreign income taxes paid, which can mitigate the fact that that income

gets taxed twice: by the United States and by the foreign jurisdiction where it is earned.

Another way companies can alleviate their tax burden is to look for ways to create wealth in countries with lower tax rates. “If your company is earning income outside the United States, you can arbitrage the differences in tax rates by structuring the company so that income is earned in a low-tax jurisdiction,” Guaraldo said.

### Six key areas of focus

Because of the complexity of rules governing certain types of transactions and earnings, there are many hazards to international tax planning. Here are six key areas to bear in mind.

**Transfer pricing.** This concept refers to the pricing for transactions between related parties in different jurisdictions, such as those between a parent company and its subsidiaries or between brother-sister corporations. Under US tax law, related parties cannot enter into such transactions on terms that would not occur if they were conducting business with a third party. For example, the production division can’t sell its products to the marketing division at artificially low prices in order to inappropriately reduce its taxable income.

A transfer-pricing study allows a company to determine the third-party comparable price on a product or service and use that as the intercompany price. “When times are tough, companies often try to avoid spending resources by not doing a study and instead playing the ‘audit lottery,’” Guaraldo said. “But the prudent thing to do is to get a transfer-pricing study so

that you have contemporaneous documentation supporting the price you set.”

**Withholding taxes.** Certain business charges—interest, royalties, dividends, and some services—are subject to withholding taxes in foreign jurisdictions. For example, if a Brazilian subsidiary of a US company pays a royalty to its parent for the use of intellectual property, the Brazilian government imposes a 25% withholding tax on that royalty payment. Since the parent company also pays US income tax on the royalty, this scenario creates a double tax. Many countries have double-tax treaties with the United States, which lower the withholding rate to 0% to 15%.

US companies that receive payments from foreign jurisdictions should consider whether there will be withholding taxes on those payments and if so, investigate whether there is a double-tax treaty dictating how that source of income would be taxed. In the example given, if the US company can’t avoid doing business with Brazil (which does not have a double-tax treaty with the United States), another option may be for it to establish a holding company from the Netherlands or another jurisdiction that does have a double-tax treaty with Brazil.

**Inefficient capital structure or intercompany debt.** US companies setting up businesses offshore can finance them with either debt or equity. Using debt—that is, loaning cash to the foreign subsidiary—allows the subsidiary to take a deduction on interest expense, which will reduce the amount of taxable income in that foreign jurisdiction. Companies may want to create a tax-efficient

debt structure, in which the lender is in a low-tax jurisdiction and the borrower is in a high-tax jurisdiction. This enables them the company to increase the difference between the tax paid on interest income and the taxable-income deduction.

**US antideferral rules.** One of the main advantages of setting up a foreign subsidiary is that it allows US companies to defer US income tax payments on the subsidiary’s earnings until the earnings are repatriated in the form of a dividend. But there are several key exceptions: foreign passive income such as interest, rents, royalties, and dividends, as well as certain types of intercompany transactions. Under Subpart F of the Internal Revenue Code, these earnings must be immediately included in US taxable income.

“The difficulty with Subpart F income is that you pay US taxes on those earnings currently, but unless you pay a dividend, those earnings are still offshore,” said Gilbertson. “So you have taxable income, but you don’t have cash from that same source to pay the tax bill.” He advises clients either to repatriate the income as a dividend or to structure the transaction in question so that it doesn’t involve buying from or selling to a related party.

**Outbound transfer of intangible assets.** The United States and many other countries have prohibitions against moving intangible assets such as intellectual property overseas. If a US pharmaceutical firm, for example, develops a new drug and uses a foreign subsidiary to manufacture and sell that drug, that subsidiary has to pay royalties to the US parent.

“Companies have to be careful of this,” said Guaraldo. “They can’t set up an operation offshore and assume that entity has the right to use the parent company’s intellectual property without paying royalties. If you do that, the US may decide you’ve effectively moved that intangible asset offshore and charge you income tax based on the value of the property moved.” Often, these exit charges mitigate—if not cancel out entirely—any benefit the company could gain from offshoring the intangible asset.

**Indirect taxes, including value-added tax (VAT) and custom duties.** US companies are often unaware of the VAT system used in most other countries (see chart). With VAT, a sales tax is imposed at each stage that value is added to a given product or service (in an oft-quoted example, when the farmer sells wheat to the miller, when the miller sells flour to the baker, and when the baker sells bread to the consumer). Although ultimately, the cost of VAT is paid by the end user, if a US company is the importer of record in a foreign jurisdiction with VAT, it is responsible for collecting and administering VAT and must therefore be knowledgeable in order to comply with local laws.

Depending on the jurisdiction, custom duties can also be significant. If a US company is exporting its goods to a country that charges high import duties, those added costs have the potential of making its products less competitive than domestically produced ones.

### Changes on the horizon

The Obama Administration has proposed several reforms to the international tax system that have the potential to seriously impact US

multinationals. If enacted, these new rules would take effect in 2011.

One proposed change would place restrictions on what are known as the “check-the-box” rules, which currently allow US companies to treat foreign subsidiaries of foreign holding companies as disregarded entities for tax purposes. (This is frequently done to plan around the Subpart F antideferral rules discussed earlier.)

“If US companies have a second-tier foreign entity that’s currently disregarded, they’ll need to reexamine that structure and see if it would generate significant Subpart F income under the new rules,” Gilbertson said. “If so, they may want to consider restructuring their foreign operations.”

Another proposal would no longer allow US corporations to take US tax deductions on expenses related to deferred foreign income until that income is repatriated (in particular, this would mean higher expenses for bank interest). Still another would create a single foreign tax credit pool based on all foreign earnings, which would restrict US corporations’ ability to maximize US foreign tax credits.

### Conclusion

With effective tax planning, US multinationals can take advantage of different tax rates in different jurisdictions without making themselves subject to the US antideferral provisions that would make some of that income taxable in the United States. Ignorance of the tax system can affect a corporation’s cash flow and its international competitiveness—especially with credit markets tight and many governments looking to balance their budgets through tax revenues.

### How should US companies operating internationally plan for the Obama Administration’s proposed regulatory changes?

1. Educate themselves and senior management on the proposals.
2. Quantify the potential impact of the proposals to their financial income and cash tax.
3. Lobby through industry groups or hold discussions with legislators in order to seek favorable revisions.
4. Plan alternatives. Planning should take two forms:
  - Prior to enactment (by 2011)
  - Postenactment

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## Comparison of tax rates worldwide

Country	Income tax corporate	Income tax individual	VAT
Austria	25%	21-50%	20%
Brazil	34%	7.5-27.5%	17-25%
Canada	19.5%	15-29%	5%
China	25%	5-45%	17%
Czech Republic	20%	15%	19%
Finland	26%	7-30.5%	22%
France	33.33%	5.5-40%	19.6%
Germany	30-33%	14-45%	19%
Greece	25%	0-40%	19%
Hong Kong	16.5%	2-17%	—
Hungary	16%	18% and 36%	20%
India	30-40%	10-30%	12.5%
Indonesia	28%	5-30%	10%
Ireland	12.5%	20-41%	21.5%
Israel	26%	10-46%	15.5%
Italy	31.4%	23-43%	20%
Japan	30%	5-50%	5% (consumption)
Luxembourg	21%	0-38%	15%
Mexico	28%	0-28%	15%
Netherlands	20-25.5%	0-52%	19%
Norway	28%	28-49%	25%
Philippines	30%	5-32%	12%
Poland	19%	18%/32%	22%
Portugal	25%	0-42%	20%
Romania	16%	16%	19%
Russia	20%	13%	18%
Saudi Arabia	20%	20%	—
Serbia	10%	10-20%	18%
Singapore	18%	3.5-20%	7%
South Africa	28%	0-40%	14%
Spain	30%	24-43%	16%
Sweden	26.3%	0-57%	25%
Switzerland	13-25%	0-13.2%	2.4-7.6%
Taiwan	25%	6-40%	5%
Thailand	30%	5-37%	7%
Turkey	20%	15-35%	18%
United Kingdom	28%	0-40%	15%
United States	15-35%	15-35%	—

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