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Cross-Border Taxation

James McCann of Kleinberg, Kaplan, Wolff & Cohen breaks down tax planning opportunities and traps for international small businesses. ''The wrong strategy or execution—in particular due to misuse of foreign entities or underreporting of foreign income—can have devastating financial and other consequences, in particular for otherwise successful businesses,'' he writes. In this first of two parts, McCann focuses on outbound planning—U.S.-owned businesses with assets or activities abroad. A second article will consider foreign investment in the U.S.

Tax Planning for the International Small Business (Outbound Edition)

BY JAMES MCCANN*

Earlier in 2014, Beanie Babies' founder Ty Warner pleaded guilty to tax evasion and agreed to pay a $53 million penalty to the Internal Revenue Service; the charges stemmed from unreported offshore bank accounts, a stark example of the ''dark side'' of international tax planning.

That is, the wrong strategy or execution—in particular due to misuse of foreign entities or underreporting of foreign income—can have devastating financial and other consequences, in particular for otherwise successful businesses. But the right strategy may provide significant benefits, such as permitting indefinite deferral of U.S. taxation of foreign-earned income or the conversion of ordinary income to long-term capital gain.

This article reviews U.S. tax planning considerations for the international small business. Rather than discussing ''structures,'' it addresses important design principles—basic issues, planning opportunities and traps. It is intended to provide small business owners and their advisers with a starting point rather than a conclusion. This article is focused on outbound planning—U.S.-owned businesses with assets or activities abroad. A future article will consider foreign investment in the U.S.

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What Is an 'International Small Business'?

As used in this article, an ''international small business'' is a business that:

- has substantial activities abroad,
- is operated as a sole proprietorship or through a flow-through entity such as a limited liability company or S corporation,
- is privately owned, and
- has owners who are principally if not exclusively U.S. natural persons.

It may be a one-man show, operating out of a suitcase via cellphone and laptop, or a large enterprise with employees, offices and assets all over the world.

The international small business may exist in any industry, such as:

- **Services:** A consultant who travels and conducts business around the world.
- **Financial:** An investment manager working out of the Cayman Islands.

- **Manufacturing:** An S corporation with offshore plant and equipment.
- **Technology:** A software designer based in Dubai.
- **Real Estate:** A developer with projects in eastern Europe.

The considerations discussed below are generally applicable to any international small business, regardless of industry. Nevertheless, certain industries or other common fact patterns may also share common issues and opportunities.

How Is It Different From 'Big Business'?

Perhaps the most important distinction is that, for a small business, shareholder and business tax planning are typically hand-in-glove. This is due to a closer identity of interest (due to more concentrated ownership) and also the prevalence of flow-through structures that result in owners (rather than the business) paying tax on the business's profits.

Differences in scale are also significant. The most important tax planning tool for multinationals—transfer pricing, i.e., moving profits from high-tax to low-tax jurisdictions through intercompany transactions—generally doesn't scale well to smaller businesses.

There are many other potential differences, including the fact that publicly owned businesses are typically organized through C corporations rather than flow-through entities. This is effectively required for tax and other reasons. It does create the disadvantage of a second layer of U.S. tax (imposed on the C corporation), but also provides significantly different opportunities relating to deferral planning.

What Is Different About International Tax Planning?

Critical differences include the potential application of non-U.S. taxes, as well as the substantial and complex U.S. income tax rules particular to offshore entities and activities. Knowledge of these and other relevant issues is somewhat specialized, and an otherwise competent and experienced tax attorney or certified public accountant may have insufficient experience with international planning.

The Worldwide Reach of the U.S. Tax System

With very limited exceptions, U.S. citizens and green card holders are subject to U.S. income taxation on their worldwide income regardless as to whether they reside within or have any other connection to the U.S. That is, the same basic rules apply to the green card holder who has lived in his native India for decades and the U.S. citizen who has never crossed a border. Thus, no matter where it is operated, the international small business needs to take U.S. tax planning and compliance into account.

People Matter

More specifically, legal entities matter. Consider Joe, a U.S. citizen who provides business consulting services to clients located around the globe. For years he has operated the business through a wholly owned LLC, and has reported its results on his personal U.S. income tax return. He has paid ''ordinary income'' tax on that income, net of expenses.

Key Considerations

- U.S. citizens and green card holders are subject to U.S. tax on their worldwide income, regardless of whether they reside in or have any other connection with the U.S.
- Choice of legal entity can significantly affect the tax treatment of businesses and owners.
- Cross-border activities may result in difficult and complex tax compliance obligations. Penalties for noncompliance can be severe and disproportionate.
- Businesses moving offshore can be subject to a ''toll charge''; individuals can face an ''exit tax'' too.

Joe decides to reorganize the business through a foreign corporation. This could have good results: U.S. taxation of income earned by the corporation may be deferred, and within a more complex structure ''ordinary income'' consulting fees may be converted to long-term capital gain. (More on these opportunities later.)

But this structure also creates important compliance obligations and other potentially significant pitfalls. The mere implementation of the structure may be taxable or present other issues, including important reporting obligations. Joe must file special tax forms to report the corporation. Failing to file these forms would result in significant penalties (generally a minimum of $10,000 for each form, for each year), and can keep the statute of limitations open indefinitely on his personal income tax return.

Joe won't be able to (personally) deduct losses incurred by the corporation. He won't be able to claim foreign tax credits for any non-U.S. income tax that it might pay.

If the corporation's activities cross into the U.S., it would likely be required to file a U.S. corporate income tax return, and pay U.S. corporate income taxes on its U.S.-source income. This corporate-level tax may make this structure tax-inefficient. If the corporation is required to but fails to timely file such a return, it is denied any deduction for its expenses.

This is just a small sample of considerations that are relevant to choice of entity for the international small business.

Deferral

U.S. persons are taxed on their worldwide income, but it may be possible to at least defer the imposition of U.S. taxes by structuring foreign business activities through a foreign corporation. Deferral may be valuable, in particular, by permitting the pre-tax reinvestment of the earnings of the business.

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There are a number of critical ingredients to successful deferral planning, including the following:

■ First, it requires that the business is operated through a foreign corporation. Moving an existing business to a foreign corporation can raise difficult issues. (Discussed below.)

■ Second, as noted above, the foreign corporation's U.S. activities must be significantly limited. This may or may not be problematic, depending on how and where the business is being operated.

■ Third, it requires navigating the various and complex anti-deferral rules of the tax code, in particular "Subpart F." Thus, passive-type income, such as dividends, interest, rents and royalties typically can't be deferred, with important exceptions for "active" rents and royalties. There are also issues for certain active businesses, such as commodities trading, as well as income from sales or services involving related persons. One unpleasant aspect of Subpart F is that so-called Subpart F income is taxed at ordinary income rates, even if the underlying income is long-term capital gain (and thus a deferral vehicle may be a particularly poor choice for investing in assets held for long-term appreciation).

■ Finally, a deferral structure generally doesn't make sense if the business is paying substantial foreign income taxes, because foreign tax credits are generally "trapped" at the level of the foreign corporation. This analysis may be complex where the business is doing business in both "high" and "low" tax jurisdictions; one possibility is to use different legal structures for income earned in different jurisdictions.

Conversion

Susannah has a manufacturing business located outside the U.S., and sells the inventory f.o.b. the factory. The business is organized through a Netherlands holding company, which she wholly owns, and its non-U.S. subsidiary.

Assuming that the Netherlands company is eligible for the U.S.-Netherlands income tax treaty and certain other requirements are satisfied, dividends from the Netherlands company to Susannah are "qualified dividends" and thus eligible to be taxed at long-term capital gain rates. That is, the dividends are taxed at a rate of 20 percent even though the underlying income would, in Susannah's hands, be taxed at an ordinary income tax rate of 39.6 percent. That is, Susannah's federal income taxes could be cut almost in half.

This is a potentially complex structure. In order for it to work, among other things, it requires that the business is operated through a foreign corporation, and thus satisfies the same requirements (and is subject to the same risks and reservations) as deferral planning. It also requires the use of an entity organized in a tax treaty jurisdiction, which may or may not be possible or efficient.

Exporters of goods and certain services may also be able to obtain conversion (and deferral) through an "interest charge domestic international sales corporation," or IC DISC. There are particular requirements and limitations to the IC DISC that are outside the scope of this article.

Moving an Existing Business Offshore

Moving an existing business into a foreign corporation can raise difficult issues, and a substantial review of these issues is outside the scope of this article. But it is necessary to dip a toe into the water.

It is possible that the move significantly backfires: Under "anti-inversion" rules, the foreign corporation may be deemed a U.S. corporation for U.S. income tax purposes, and thus subject to U.S. corporate income tax on its worldwide income. If the business was previously organized as a U.S. LLC or an S corporation, this can result in the creation of a substantial additional layer of U.S. taxation. The scope of the anti-inversion rules is extremely broad, and would facially apply to the movement of a typical international small business offshore (other than a sole proprietorship).

Alternatively, the move may be subject to "toll charge" rules, whereby the move is immediately wholly or partially taxable, or creates a future stream of imputed income that is subject to U.S. taxation. Under the toll charge rules the move's form and supporting documentation may have significant consequences for its ultimate tax treatment.

Moving Yourself Offshore

As noted above, U.S. citizens and green card holders are subject to U.S. income taxation on their worldwide income. This can be remedied by giving up one's citizenship or green card. This has obvious and significant immigrant-related consequences. As for taxes, the cure may be worse than the disease. In particular, high income or high net worth persons are typically subject to an "exit tax," which can be a particular problem for the owner of a closely held business.

This tax is applied as if the expatriate sold his or her worldwide assets on the date of expatriation, at fair market value. A closely held business may be difficult to value, and thus leaves the expatriate with a (potentially) wide range of tax liabilities. In addition the illiquidity of such a business may present a problem as to how to pay the exit tax.

Pre-expatriation planning is essential in these situations.*

Conclusion

Successful tax planning for the international small business doesn't come off the rack. It may or may not be simple, and it may present opportunities and risks that are different—and in many cases more significant—than those applicable to wholly domestic enterprises. But it needs to take into account the personal situations of its owners, the size of the business, the cost of setup and compliance, and many other variables particular to the business and its owners. It needs to take into account future growth and other potentialities. These considerations require care and good counsel.

* See e.g., James McCann, "Ten Surprises for Expatriates"(201 DTR J-1, 10/17/13).