102K7N

Send to: PUREVDORJ, MUNKHSELENGE
WAKE FOREST UNIVERSITY SCHOOL OF LAW
1834 WAKE FOREST DR
WINSTON SALEM, NC 27109-8758

Time of Request: Monday, November 15, 2010 10:24:43 EST
Client ID/Project Name:
Number of Lines: 219
Job Number: 1821:253323976

Research Information

Service: Terms and Connectors Search
Print Request: Current Document: 1
Source: Doing Business in the United States
Search Terms: § 12.11 Special Problems of Foreigners Doing Business in the United States

Doing Business in the United States

CHAPTER 12 Taxation of Nonresident Alien Individuals and Foreign Entities

2-12 Doing Business in the United States § 12.11

§ 12.11 Special Problems of Foreigners Doing Business in the United States

Once a foreigner wishing to do business in the United States has made a thorough analysis of his or her short and long-term goals and objectives, and has then worked through the tax consequences they entail under basic United States law and under treaties, he or she will have a fairly accurate picture of the tax treatment he or she can expect to receive in the United States. However, the picture will not be complete until a number of special tax problems are considered. Of these special problems, there are of primary importance: (1) the foreign tax credit, (2) allocations under Section 482, and (3) required revenue rulings under Section 367.

[1] The Foreign Tax Credit

It should be understood at the outset that "foreign" in this context means the foreign taxes paid or deemed paid by United States businesses doing business, or otherwise taxable in foreign countries. Thus, the foreign tax credit can be claimed only by United States taxpayers--domestic corporations, United States citizens wherever located, and resident aliens of the United States who pay, or are deemed to pay, foreign taxes which qualify as income taxes to foreign governments. True foreigners (nonresident aliens and foreign corporations or other entities doing business abroad) are never entitled to United States foreign tax credits. n1 (Note, however, that some treaties may provide special foreign tax credit adjustments for foreigners. n2) Thus, the foreign tax credit will only be relevant, as a general rule, to foreigners doing business in the United States if they have set up their business through a United States taxpaying entity, such as a United States corporation, or if the foreigners have become United States residents. n3 In either case (United States entity or United States resident), if the foreigner or the United States entity also has worldwide income subject to income taxes by foreign governments, the foreigner or entity will be entitled to claim foreign tax credits. n4

The chief significance of the foreign tax credit n5 is that it is a *credit*, not a deduction. This is usually a valuable bonus, since many foreign governments impose taxes at a rate lower than the United States tax rate. Qualifying taxes are not required, however, to be credited; they may also be deducted by the taxpayer under *I.R.C. Section 164*--if a taxpayer chooses not to take a credit, then he can still get a deduction. The chief reason why a taxpayer would *not* want to take the credit is the limitation on the credit built into the rules of the Code.

This limit basically provides that foreign taxes may be credited, in separate categories or "baskets," only to the extent that they do not exceed the amount of tax the United States would have imposed on the foreign source income of that same basket, computed under United States income tax rules, as if the income had been earned in the United States. The

deduction is not subject to any such limitation. n6

No credit may be taken for foreign taxes which exceed the limitation in any taxable year. However, to the extent foreign taxes do exceed the limit, they can still provide some benefit, in the form of carrybacks/carryovers, so that the excess credits for any year may be carried back two years and forward five years. However, even with the carryovers, the excess credits may be used only to the extent there is "excess limitation" in the year to which they are carried. Thus, they may be used only to the extent that the limitation, in any year, exceeds the amount of creditable taxes actually paid in that year. If there is no "excess limitation" in any of the seven carryover years, the excess credits are lost.

Where the United States taxpayer is a corporation, and conducts its foreign business through a subsidiary, the foreign subsidiary is treated as a separate taxpayer, and the United States parent may not claim the foreign taxes paid by the subsidiary as a direct credit. However it may claim a credit indirectly if it owns at least 10% of the stock of the subsidiary, by claiming a credit when the subsidiary pays a dividend to the United States parent. The computation is quite complex, but in a nutshell, the United States parent is entitled to claim, as a credit, that portion of the dividend it receives which represents a ratable share of the total qualifying foreign taxes paid by the subsidiary. In other words, a certain amount of qualifying foreign taxes was paid to generate the dividend.

In practice, the foreign tax credit is exceedingly complicated. The credit is mentioned here because in an appropriate case--where the foreigner intends to become a United States resident or do business through a United States entity--and the foreigner also anticipates that its United States business will have worldwide income taxable in places other than the United States, then the foreign tax credit is an important element of tax planning. Where the foreigner does *not* intend to be a United States resident, or where the foreigner's United States business will be limited to the United States only, the foreign tax credit will not arise as a planning issue.

[2] Allocations Under Section 482

Unlike the foreign tax credit, I.R.C. Section 482is always a potential problem. The reason is that Section 482 confers enormous power upon the I.R.S. to reallocate income, deductions, credits or allowances among any related organizations, trades or businesses in order to insure a proper reflection of income. This is especially important where foreigners are involved, since separate, related entities are often employed by foreigners to carry on trades or businesses throughout the world. The I.R.S. is increasingly aggressive in scrutinizing the allocations of income and deductions made by multinational businesses.

The key to understanding Section 482 is to understand when it applies. The first requirement for application is that there must be more than one entity. For this purpose, entity includes any other sort of entity, whether taxable or not, such as a partnership, a sole proprietorship, a trust or estate, or even an association, which is an unincorporated group of individuals who operate as a corporate enterprise.

The next requirement for the application of Section 482 is that the entities must be under common control or ownership. In this case, control is much more important than ownership, since actual, practical control of the entities will be sufficient, even where common ownership is not present. Furthermore, the control may be exercised by a group of persons, even though (1) unrelated, and (2) none could individually control the various entities, so long as the group of persons in control acts in concert to exercise joint domination of the entities.

Finally, there must be a shifting or transfer of income or property from one entity to another for Section 482 to apply. Thus, if a single shareholder or a group of shareholders controls three different corporations, Section 482 will only apply where the corporations do business with each other, or in some similar manner have transfers of income, deductions, credits or allowances. If the three corporations were in three wholly separate businesses and no assets were transferred from one to another, Section 482 would not apply. By the same token, if two of such corporations did conduct business together, then, to the extent that income, deductions, credits or allowances would have to be allocated

between them, Section 482 could apply. In this case, since the third corporation has nothing to do with the other two corporations (except that it is under common control with them) Section 482 could not apply to the third corporation. If this third corporation were a United States entity, doing business in the United States, but controlled by foreign shareholders, and both the other related corporations were foreign corporations doing no business in the United States, then, although Section 482 might technically apply to the two foreign corporations, as a practical matter, this application would be irrelevant: the United States would have no interest in the allocation of income or deductions among the foreign entities having no connection with the United States, and Section 482 would not have any application to the United States entity, since there has been no shifting of income or property in which the United States entity is involved.

It should also be noted that the individual, or group of individuals, who exercise control over the corporations may also be treated as an entity. Even if the three corporations previously discussed have no business among themselves nor transactions, if the controlling shareholders have transfers to or from any of the corporations, Section 482 may also apply. For example, if the shareholders should sell a piece of real estate to one of the corporations, then a transfer has been made among related entities, and Section 482 could apply. If the corporation were a United States entity, and the real estate were sold at an inflated price by foreign shareholders not engaged in a United States trade or business, the inflated price would increase the shareholder's tax-free gain, and also increase the United States corporation's basis in the property for depreciation purposes. n7 In this case, the I.R.S. would apply Section 482 to reallocate the inflated price down to a reasonable price, with the effect on the corporation of reducing its basis, and on the shareholders of charging them with dividends, taxable by the United States (absent a treaty) at the 30% withholding rate.

Wherever Section 482 is applicable, the I.R.S. has the power to make virtually any adjustment of income, deductions, credits, allowances, basis, or any other adjustment it deems appropriate. These adjustments are not made in a vacuum. For example, where income of one member of a controlled group is increased, I.R.S. is required to make a "correlative adjustment" of an equal amount somewhere else in the controlled group. This would normally take the form of a decrease in the income of one or more of the other members. In the previous example involving the sale of real estate to a controlled corporation at an inflated price, the downward adjustment in basis was offset by the upward adjustment of a dividend to the shareholders, equal in amount to the basis reduction. As it happened, both these adjustments hurt the taxpayers, but in many cases, a harmful adjustment one place will be balanced by a beneficial adjustment elsewhere.

The purpose behind the I.R.S.'s broad powers under Section 482 is to insure that members of related groups deal with each other at arm's-length, and don't manipulate various aspects of a transaction to avoid taxes. If, for example, one member of a controlled group sells goods to another, then Section 482 will apply so that the I.R.S. can make certain that the sale price is an arm's-length price, and not unreasonably inflated or reduced in order to artificially shift taxable income from one member to another. Likewise, where one member loans money to another, Section 482 will apply to insure that the interest rate is reasonable, so that (1) deductions are not shifted from one member to another, or (2) dividends deducted as interest payments. Of course, Section 482 can apply to any potential income shifting device or scheme, but its most important application will arise in the case of sales of both tangible and intangible personal property. It also can be applied in the context of sales of intangible property and services, but it is more difficult to do so. n8

Thus, where a foreign manufacturing corporation sells goods to its United States sales subsidiary, or where a foreign controlling shareholder sells goods to his or her United States corporation, Section 482 will apply to insure that the United States corporation (or other entity) deals with the foreign parent or controlling shareholders on an arm's length basis in terms of the price the United States corporation or business entity pays to the foreigners for the goods. In situations like this, the taxpayer may select a standard pricing methodology, as described below or create one of his or her own, to support the transactions were conducted on an arm's length basis. The regulations set forth in great detail what the various methodologies require, and moreover, that records concerning these pricing justifications be made contemporaneously with the transactions, and not at a later time, e.g., in preparation for tax audit.

Three tests set out in the regulations, are summarized below:

(a) comparable uncontrolled price test,

(b) resale price test, and

(c) cost-plus test.

There is no order in which these tests are to be applied. The most appropriate test should be applied in each situation, bearing in mind that the taxpayer bears the burden of proving the test used is the most appropriate.

[a] Comparable Uncontrolled Price Tests

The simplest of the three tests looks to the price at which substantially similar goods would be sold by a seller to an unrelated buyer: the test is the traditional fair market value test--looking to the price at which the goods would exchange hands between a willing seller and buyer in a normal business setting. For the test to apply, it is necessary that the goods not be unique--otherwise, there would be no comparable sales. If the goods are not unique, and substantially similar goods are sold in similar quantities under similar circumstances, by one unrelated party to another, then the price at which those substantially similar goods are sold will be the applicable price under Section 482. n9

[b] Resale Price Test

This test is applied only where there are no comparable uncontrolled sales. If there are none, then two more requirements must also be met. The first is that the controlled buyer is merely a middleman in the sense that he resells the goods without altering the goods in any substantial way, or otherwise adding something of value to them. The second requirement is that a resale, or retail price is ascertainable shortly after the controlled sale is made. Thus, if goods are sold in a controlled sale, and then not resold or priced for resale until two years later, this test could not apply.

Where all the requirements are met, this test begins with the resale price, and reduces it by an appropriate mark-up or profit percentage. The controlled sale price is ignored, and the arm's length price is deemed to be the resale price less the profit an independent, uncontrolled middleman or retailer would normally expect to make.

It may not be easy to determine what an appropriate mark-up percentage is, but such factors as industry-wide practices, or any other indicia of profit from uncontrolled businesses marketing similar goods, will be employed. The I.R.S. agent will gather what information he can and the taxpayer will do the same, so that a comparison of all the figures will often result in a price on which both parties can agree.

[c] Cost-Plus Test

This method, which applies only where the first two tests do not, begins with the cost of producing goods. To this cost, which the taxpayer must demonstrate to the I.R.S. with reasonable certainty, the taxpayer adds an appropriate gross profit percentage, to determine a fair arm's-length price for the goods, which will include the producer's profit. This percentage will generally be the seller's normal profit percentage on other goods that it produces and sells in uncontrolled sales. For example, if a foreign manufacturer produces diesel engines for tractors and locomotives, and sells all of its tractor engines to its controlled United States subsidiary which then completes the manufacture of the tractors, but sells all of its locomotive engines to an unrelated United States manufacturer, the profit percentage on the locomotive engines would also be the profit percentage to be applied to the cost of the tractor engines. In this case, it is possible that the comparable uncontrolled price test would apply, since the engines may be substantially similar. However, the engines may be quite dissimilar, so that that test would not apply, in which case this test would. Even if the goods produced are very dissimilar, such as tractor engines and electrical transformers, this test can still apply, since it is reasonable to assume that the foreign manufacturer expects a comparable profit from any of its divisions, and

probably accounts for its costs in each division, tractor engines and transformers, in much the same way.

Usually, one of these tests will apply. However, where the goods are unique, such as goods produced under a patent sold only in controlled sales, there may be instances where none will apply. In that case, the taxpayer's method of calculating price may be acceptable to the I.R.S., but the taxpayer should be prepared to support his or her pricing method by the use of experts, such as economists. This highlights another advantage of using a United States subsidiary rather than a branch--under Section 482, only the specific goods requiring an arm's length price are in issue. Where a branch is employed, the foreigner's worldwide income is in issue, since the tests under I.R.C. Section 863look to the operations of the foreigner as a whole, rather than merely specific transactions between the foreign parent and the United States subsidiary. (Actually, Section 482, as already discussed, reaches much more than mere pricing, since it covers compensation, loans, etc. as well. But the great majority of Section 482 adjustments, at least in terms of money involved, are pricing adjustments. Furthermore, there are many more precedents for pricing adjustments under Section 482 than there are precedents under Section 863).

Finally, Section 482 is important to foreigners wherever a treaty n10 is involved, since the Competent Authority is available to taxpayers under treaties when Section 482 adjustments are made. In the United States, the Competent Authority is two officers of the I.R.S., and their chief interest in Section 482 matters is to insure that economic double taxation does not result from Section 482 adjustments. It is possible that the United States Competent Authority will not agree with its foreign counterpart, but the chances are extremely good that some agreement will be reached. As a practical matter, the Competent Authority may not be that easy to use, since it can take a number of years, but it is always available in Section 482 cases under treaties.

In conclusion, the best way to avoid abuses (and Section 482 problems) is for the foreigner to make a good faith effort to treat his or her various entities as equals, and allow each to make a fair profit. Thus, loans should be made at interest rates close to prevailing rates. Compensation should be reasonable. Prices should be set, so far as possible, as if the various entities were, in fact, unrelated, and dealing at arm's-length. If a foreign manufacturer would happily sell his or her products to an outsider for $100 per unit, he or she should not sell them to his or her controlled United States subsidiary for $200 per unit, since Section 482 will require a reallocation, to increase the taxable income of the United States entity by reducing the price it pays to $100. If, on the other hand, the foreigner sold those same goods to his or her United States entity at $90 per unit, Section 482 should apply, but in practice may not at all, since the I.R.S. may not even notice the slight "shaving". In any case, Section 482 is seldom likely to be raised by the United States unless it appears that the foreigner is attempting to *reduce* his or her United States entity's income--if he or she *increases* the United States entity's income, by reducing foreign profits, his or her problem is more likely to be with the foreign taxing authorities.

The main point about Section 482 is that it is a very powerful tool that the I.R.S. can use when appropriate, and should always be considered in tax planning for foreigners doing business through various entities. Once its purpose is understood, however, it should not be especially difficult to avoid problems with it, since the foreigner is often in as good as, or a better position than, the I.R.S. when it comes to knowledge of business practices or valuation of property. Since Section 482 is mainly designed to insure arm's-length business practices and valuation, the foreigner who plans his or her affairs carefully should not be unduly hampered.

FOOTNOTES:

(n1)Footnote 1. *See I.R.C. §§ 901(b)(4)* and*906(a)* .

(n2)Footnote 2. *See § 12.08 above*.

(n3)Footnote 3. The foreign tax credit is allowed for accumulation distributions of trusts made in trust tax years beginning after 1975. *I.R.C. §§ 665(d), 667(d)*, respectively added and amended by Revenue Act of 1978 § 701(q).

(n4)Footnote 4. If an individual is entitled to a foreign tax credit under a United States income tax treaty with a foreign country, he or she may not claim the credit if it is allocable to income which he or she has excluded as income earned abroad. *Rev. Rul. 79-199, 1979-1 C.B. 246* .

(n5)Footnote 5. *See § 11.02 above*.

(n6)Footnote 6. Effective for tax years beginning after December 31, 2006, the number of foreign tax credit baskets is reduced to two from nine. The two baskets will be passive category income and general category income (*see I.R.C. Section 904*). Passive category income is defined as passive income as well as the following: Dividends from a domestic international sales corporation ("DISC") or former DISC [as defined in *I.R.C. Section 992(a)*] to the extent that such dividends are treated as income from sources not including the United States; Taxable income attributable to foreign trade income [within the meaning of *I.R.C. Section 923 (b)*]; and Distributions from a foreign sales corporation ("FSC") or former FSC out of earnings and profits attributable to foreign trade income or interest, or carrying charges (*see I.R.C. § 927 (d)(1)*) derived from a transaction which results in foreign trade income. General category income is defined as income other than passive category income and includes financial services income. American Jobs Creation Act of 2004, Pub. L. No. 108-357.

(n7)Footnote 7. For discussion of depreciation *see § 8.03[4]*.

(n8)Footnote 8. Final regulations on transfer of intangibles were issued under Section 482 in 1995; final regulations governing cost sharing arrangements were issued in December, 1995 and May, 1996.

(n9)Footnote 9. For discussion of sales under the Uniform Commercial Code *see* Ch. 14 *below*.

(n10)Footnote 10. For discussion of tax treaties *see § 12.08 above.*