



Wichita State University

International Tax Update

Presented by

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International Tax Update

- Subpart F: Look-through Rule and Country of Incorporation Exception
- Subpart F: Section 956 and Limited Relief
- Canada/US Treaty – New Protocol
- Commonly Missed International Forms
- IC-DISC Planning Overview



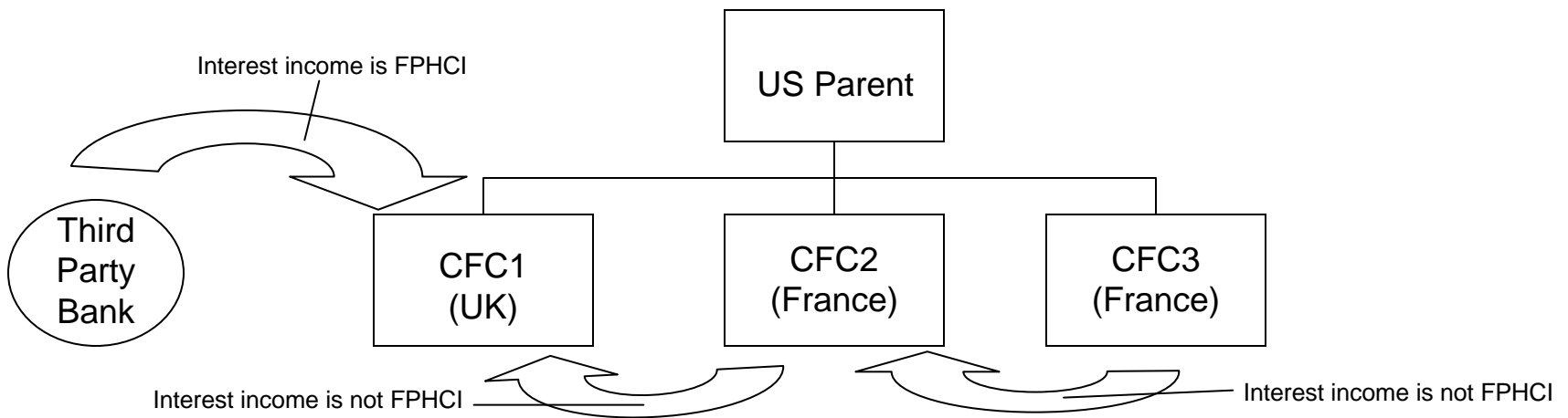
I. Subpart F: Look through and Country of Incorporation Exception



Subpart F Issues

- Subpart F income
 - Failure to identify and report foreign personal holding company income
 - Failure to identify and report foreign base company sales income
 - Failure to identify and report Section 956 investment in US property

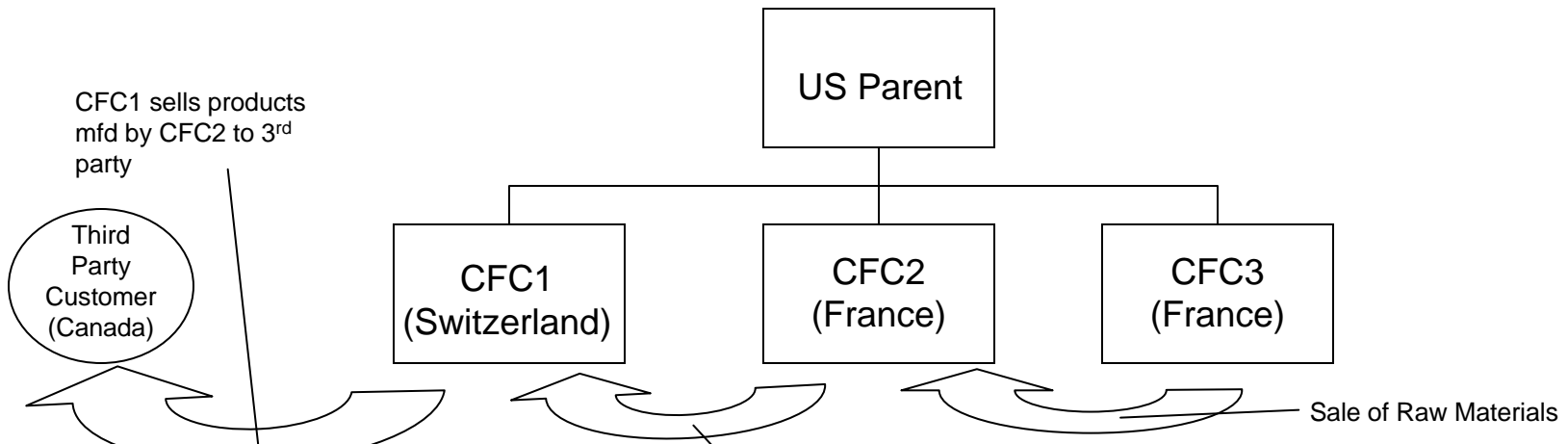
Foreign Personal Holding Company Income



Foreign Personal Holding Company Income is generally passive types of income earned by a CFC

- Interest earned by CFC1 is FPHCI
- Interest paid from CFC2 to CFC1 normally FPHCI
 - In 2004, an exception for CFC to CFC payments eliminated this as FPHCI
 - The provision was set to expire 12/31/08
 - Extended by the 2008 Extenders Act to tax years of CFCs beginning before 1/1/2010
- Interest paid by CFC3 to CFC2 is not FPHCI
 - Deemed not to be abusive because both entities are organized in France (same country exception)

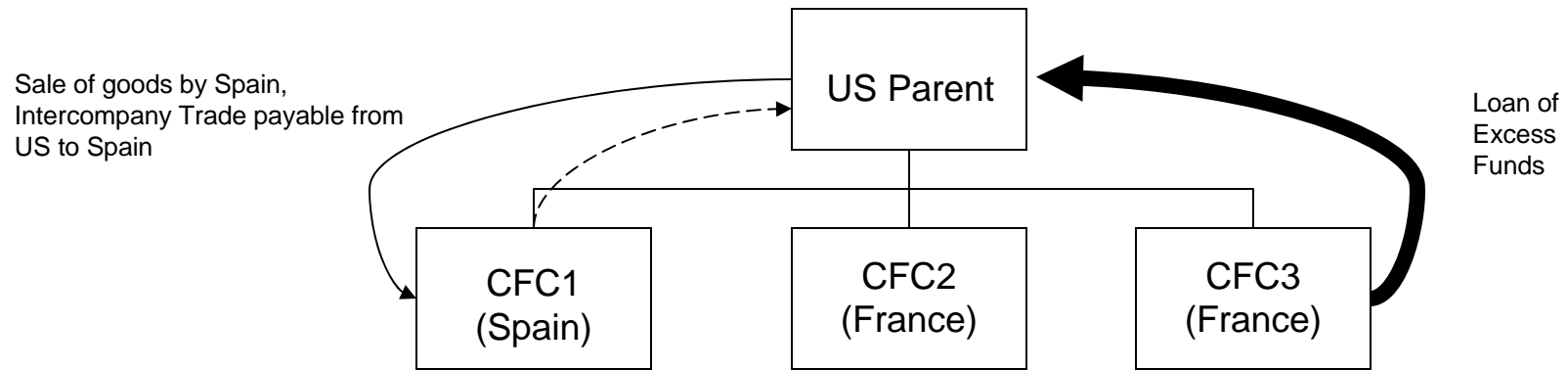
Foreign Base Company Sales Income



Foreign Base Company Sales Income

- Sale of product to a related party
 - Where product was not produced
 - By the seller or
 - In the country of incorporation of the CFC and
 - For consumption outside the country of incorporation
- Sale by CFC3 to CFC2 is not a problem
 - Same country exception (France to France)
- Sale by CFC2 to CFC1 is not a problem
 - Product produced by CFC2
- Sale by CFC1 to Third Party is a problem
 - CFC1 did not produce the property
 - Property was produced outside of Switzerland
 - Produce is for consumption in Canada

Investment in US Property (Section 956)




- CFC3 has an investment in US property to the extent US Parent has borrowed.
 - Notice 2008-91 permits loan to the extent it is settled within 60 days
- CFC1's sale of product to US Parent generally does not give rise to an Investment in US property
 - But make sure the intercompany account is settled periodically. If the liability is not settled, there could be a deemed loan from CFC1 to US Parent.



Section 956 -Subpart F through Investment in US Property

- CFC's normally cannot invest in US property without creating current income inclusions via Subpart F
- The policy rationale is that if money is brought into the US, taxation should result because while a distribution has not been made, the Taxpayer has the funds safely in the US and further deferral of taxation should not continue



Section 956—Earnings Invested in US Property

- A US shareholders gross income includes a pro rata share of any increase in CFC investment of CFC earnings in US property.
- Items frequently missed as investments in US property are US parent pledges of more than 66 2/3% of stock in a CFC, loans by the CFC to the domestic parent or US affiliate, or pledges or guarantees by CFC of loan taken by US parent



Section 956 Inclusion

- The amount included in income is the lesser of:
 - The excess of the shareholder's pro rate share of the average of the amounts of US property held by the CFC as of the end of the quarter of such taxable year over E&P or
 - The shareholder's pro rate share of the applicable E&P



Temporary Relaxation of Section 956 due to Financial Crisis

- Notice 2008-91 provides relief in what is termed an obligation for purposes of Section 956
- Obligation paid within 60 days of issuance is not treated as an investment in US property, however exception is not applicable on successive 60 day loans if investment in aggregate is held more than 180 days in the year
- Notice 88-108 previously provided a more limited exception if an obligation is paid within 30 days of being incurred and overall was held for less



II. Commonly Missed International Tax Issues



Policy change with Form 5471 penalties

- The \$10,000 failure to file penalty will be imposed whenever there is a failure to file a Form 5471 when required. Abatement requests may be filed but likely will be more difficult to obtain with this change in policy that appears focused on the tax gap.



Commonly Missed International Tax Issues

- Incorrect currency conversions on Form 5471
- Failure to report officers and directors on Form 5471, page 1
- Failure and incorrect reporting of related party transactions on Form 5471, Schedule M
- Reporting accounts payable as loans on Form 5471, Schedule M
- Failure to file Form 5471, Schedule O when a foreign corporation is organized or has a reorganization
 - Failure to add organizational chart
- Failure to report transfer to foreign corporation on Form 926



Commonly Missed International Tax Issues

- Failure to allocate and apportion expenses in calculating FTC on Form 1118
- Understatement of foreign source income in calculating FTC under Section 863(b) sourcing rules
- Failure to file Form 5713 (international boycott form)



Commonly Missed International Tax Issues

- Failure to make Sec. 338 election for foreign subsidiary when beneficial
- Failure to make dual consolidated loss election
- Failure to claim extraterritorial income exclusion
- Failure to identify transfer pricing exposure or planning opportunities
 - New transfer pricing regulations regarding cost-sharing arrangements are expected



Commonly Missed International Tax Issues

- Failure to file Form 1042, Form 1042-S and 1042-T (annual withholding tax return)
- Failure to provide for Section 1446 (Forms 8804, 8805, and 8813) withholding for foreign partners whether or not distributions made; Form 8813 is required on or before the 15th day of the 4th, 6th, 9th, and 12th month of the partnership's tax year
- Failure to attach legal entity organization chart for Forms 8858



III. New Protocol to US/Canada Income Tax Treaty Ratified by US Senate and In Force January 1, 2010



New Fifth Protocol to US/Canada Income Tax Treaty

- Prior to ratification of US/Canada protocol, a LLC was not a resident for treaty purposes because it was not "liable to tax" (unless it elected to be taxed as a corporation for U.S. federal income tax purposes).
- As a result, a U.S. taxpayer that invested in Canada through a U.S. LLC was not eligible for treaty benefits, even if owned 100% by U.S. resident taxpayers.
- This caused interest, dividend, or royalty payments made to a U.S. LLC from Canada to be subject to a 25% Canadian withholding tax, rather than the reduced treaty rates.
- In addition, LLCs which carried on business in Canada were subject to Canadian income tax even if the LLC did not have a permanent establishment (PE) in Canada.



New Fifth Protocol to US/Canada Income Tax Treaty

- Under the 5th Protocol ratified by the US Senate on September 23, 2008 a new paragraph 6 was added that (while not defining an LLC as a taxpaying entity) indicates that payments of interest, dividends or royalties from Canada to a US LLC that is wholly owned by US taxpayers would be eligible for the reduced withholding rates under the treaty.
- Once the Protocol is effective Jan. 1, 2010, dividends are eligible for the 5% or 15% w/h tax as opposed to 25% w/h generally
- Interest may be exempt from withholding entirely
- Royalties are subject to a 10% w/h tax



New Fifth Protocol to US/Canada Income Tax Treaty

- However, under new Protocol no new reduced rate of withholding is allowed an otherwise qualifying US resident shareholder of a Unlimited Liability Company “ULC”
- Accordingly, 25% withholding is required as of Jan. 1, 2010.
- Contact BKD, Intl. Tax with regard to migration strategy for affected Taxpayers




IV. Interest-Charge Discs (a no-brainer planning opportunity in a challenging economy for companies with foreign export sales)



Domestic International Sales Corporation (DISC)

- *Jobs and Growth Act of 2003* provides reduced tax rate of 15% on qualified dividends received by individuals through 2008
- *Tax Increase Prevention and Reconciliation Act of 2005* extends reduced tax rate of 15% on qualified dividends received by individuals through 2010
- 15% dividend presents opportunity to reduce tax on export profits through DISC

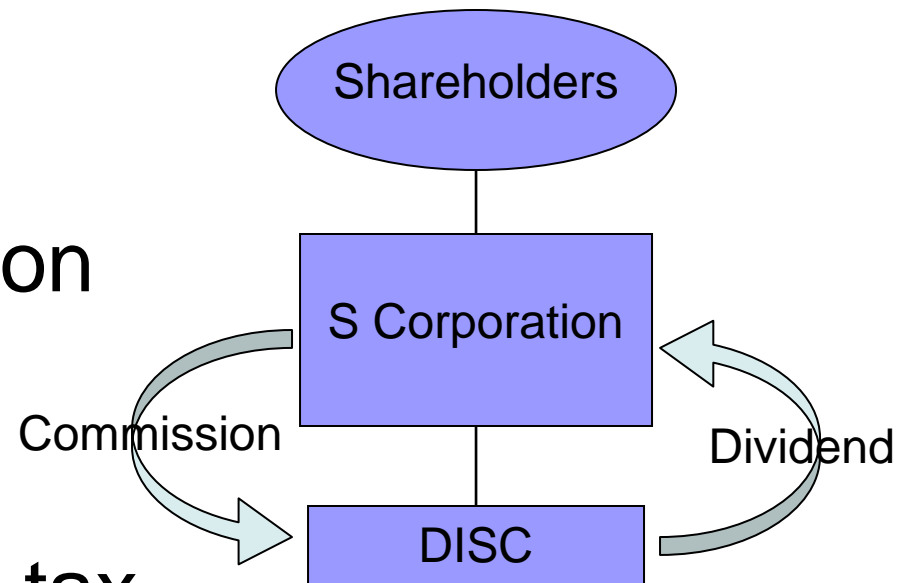


Domestic International Sales Corporation (DISC)

- DISC benefit arises as follows
 - Commissions paid to DISC reduce taxable profit of related supplier corporation
 - DISC is tax-exempt entity
 - DISC dividends received by individual shareholder taxed at 15% rate

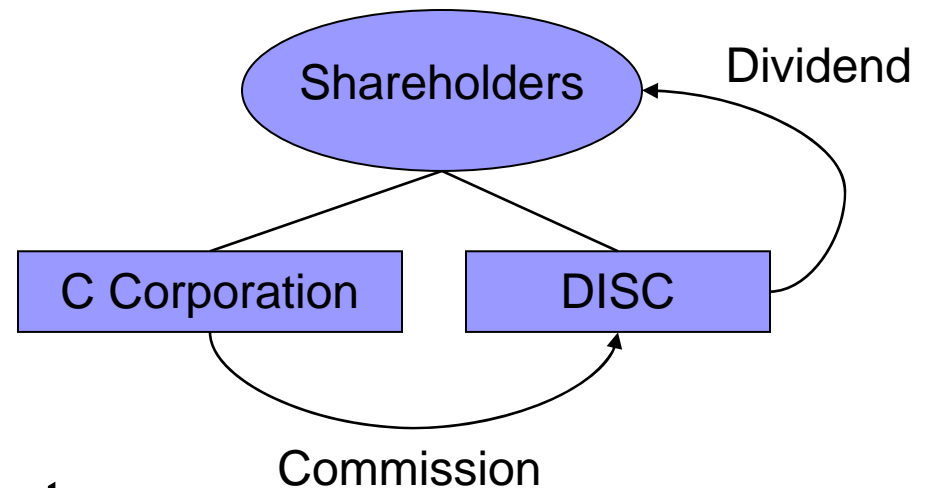
Possible DISC Structures


- Commission reduces taxable profit passed through to S corporation shareholder (35% tax savings)
- DISC is not subject to tax
- S corporation shareholders pay 15% tax on DISC dividends



Possible DISC Structures


- Commission reduces taxable profit of C corporation (34-35% tax savings)
- DISC is not subject to tax
- C corporation shareholders pay tax at 15% on DISC dividend





Domestic International Sales Corporation (DISC)


- DISC commission equals greater of
 - 50% of export profits
 - 4% of qualified export receipts, not to exceed 100% of export profits
- DISC shareholders permitted one-year deferral on DISC profits on qualified export receipts on \$10 million or less



Domestic International Sales Corporation (DISC)


- Interest charge on tax benefit on accumulated DISC income. U.S. T-bill rate used to calculate interest charge.

Note: 15% tax rate on qualified dividends scheduled to sunset after 2010



Domestic International Sales Corporation (DISC)

- Domestic corporation (C corporation)
- \$2,500 capital
- Single class of stock
- File timely elections (Form 4876-A within 90 days from beginning of tax year)
- 95% qualified export asset test
- 95% qualified gross receipts test



Domestic International Sales Corporation (DISC)

- Interest charge on deferred income
- Deemed distribution of taxable income on export gross receipts >\$10 million



Categories of Gross Receipts

- Sale, exchange or other disposition of export property
- Lease or rental of export property used by lessee outside U.S.
- Services that are related & subsidiary to any qualified sale, exchange, lease, rental or disposition of export property



Export Property for DISC (1.993-3)

- Manufactured, produced, grown or extracted in U.S. by person other than DISC
- Held primarily for sale, lease or rental for direct use, consumption or disposition outside U.S.



Export Property for DISC (1.993-3)

- 50% of fair market value of export property can be attributable to foreign content
- Consider qualified export property sold to U.S. distributors



Other Considerations

- DISC commission reduces QPAI deduction
- DISC commission reduces profit on foreign title transfer sales (Sec. 863(b)) & may reduce foreign tax credit utilization
- 2006 proposed technical corrections legislation denying 15% individual rate on DISC dividends
- “Rangel Bill” introduced October 2007 would repeal DISC statutes for taxable years beginning after December 31, 2007



Other Considerations

- Technical corrections legislation introduced in November 2007 would disallow 15% individual rate on DISC dividends (Section 8). Adverse DISC provision was dropped from final bill passed on December 18, 2007
- Provide for deferred tax on accumulated DISC income (FAS 109/APB 23)
- Financing arrangements
- State income tax considerations



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