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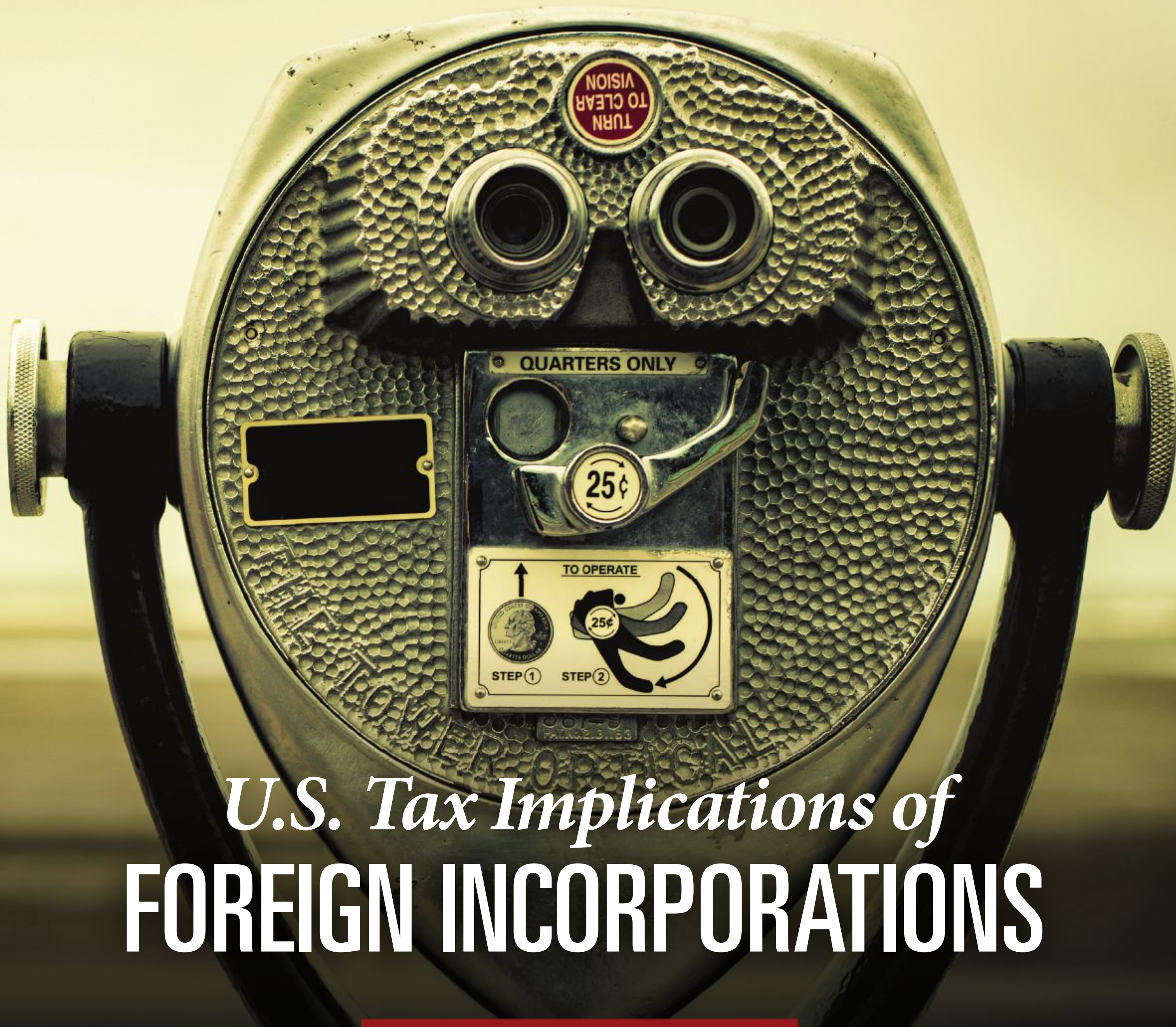

U.S. Tax Implications of FOREIGN INCORPORATIONS

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U.S. Tax Implications of FOREIGN INCORPORATIONS

Anthony Malik, EA

Introduction

Growing businesses often explore and gradually expand into new markets. This expansion (depending on a particular business's nature and ambitions) may be local, regional, or international in scope. Internationally expanding business, depending on cross-border activity levels, may delve into foreign markets in one of several ways. These may include:

- Domestically conducting sales with persons abroad
- Licensing products to a foreign business
- Entering a joint venture with a foreign partner
- Starting a foreign branch
- Establishing a foreign subsidiary

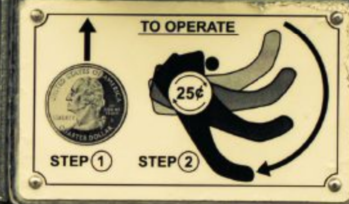
These market entry modes have unique advantages and disadvantages that must be considered in light of a U.S. business' entity type, functions, and objectives. In practice (driven by myriad tax and nontax considerations) many businesses eventually establish foreign subsidiaries once they gain a foothold in a foreign market. Remember: a foreign subsidiary is a foreign corporation chartered abroad to locally conduct foreign operations.

This article is an introduction to the U.S. tax implications of transfers effectuating outbound incorporations. Namely, this means establishing a foreign subsidiary. While this article assumes the U.S. business to be a regular corporation (C-Corporation), it should be noted that the tax laws governing foreign incorporations are indiscriminately applied to all taxpayers—regardless of type.

Tax Law's Security Checkpoint

Assets transferred across the U.S. border to form a foreign corporation acquire a fleeting, character deserving scrutiny. The mechanism of this scrutiny, anatomized within IRC Sec. 367, vitiate the gain nonrecognition rules of IRC Sec. 351. Specifically, while IRC Sec. 351 covers the incorporation of a foreign business, IRC Sec. 367 limits its scope. As a matter of policy, the anti-nonrecognition rules of IRC Sec. 367 are designed to deter taxpayers from shifting the potential income of U.S. impetus outside the U.S. taxing jurisdiction. As a matter of practice, the law requires a two-tiered assessment of outbound transfers. This is to say that practitioners first must determine the applicability of IRC Sec. 351 followed by determining the applicability of IRC Sec. 367. To travel across the U.S. border tax-free, the transfer must meet the tests of the former and qualify for one of the uncontested exceptions to the general rule of the latter.

The general rule of IRC Sec. 367 denies gain nonrecognition any time an asset leaves the U.S. taxing jurisdiction. Interestingly, the language of the law denies this gain nonrecognition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deductively. This suggests that rather than directly addressing the transfer, the statute denies the transferee corporate status for purposes of the transaction. This results in the annulment of IRC Sec. 351 and thereby annuls gain nonrecognition. IRC Sec. 367, from the onset, quickly unfolds into an intricate legal constellation by cross-referencing numerous code sections, superimposing exceptions upon exceptions, and so on. For the purpose of our discussion, we will limit the subject to the major exception to the general rule: The foreign trade or business exception, along with the most common exceptions to this exception. Delving any deeper would require a science-grade telescope.

Trade or Business Exception

It is useful to briefly consider the rationale of the general rule before meditating on any appurtenant exceptions. The general rule denying gain nonrecognition is, in fact, a very viable way of combating tax avoidance. Consider that in the absence of the general rule, astute taxpayers could transfer appreciated assets across the U.S. border in a tax-free IRC Sec. 351 transaction and arrange for a sale via the foreign subsidiary. The gain from this hypothetical sale would avoid U.S. taxation—even though the built-in gain (the appreciation in the asset's value), would be U.S. source income. Keeping with this concept, one can see that IRC Sec. 367 acts as a backstop to this potential loophole. However, the law then has to extend exceptions to transactions lacking a tax avoidance motive. Thus, the primary exception is made for transactions with a bona fide business purpose.

The major exception to the general rule of IRC Sec. 367 preserves the transferee's corporate status whenever the transferred assets are legitimately meant for use in an active trade or business outside the U.S. In turn, this extends gain nonrecognition to the transaction, rendering it tax-free. The regulations impose a stringent, four-part test that must be completed in order to qualify for the trade or business exception (Treas. Reg. Sec. 1.367(a)-2T).

Very broadly, the four provisos that must be satisfied are :

1. A legitimate trade or business must exist. The law essentially states that an enterprise meets the legal definition of a trade or business when it sufficiently and substantially constitutes the necessary business processes and procedures essential to independently conduct profit-oriented activities. In other words, the trade or business must be a reasonably complete and self-sustained operation—not simply a collection of functions that are ancillary to the conduct of a trade or business.
2. The transferee must actively engage in the conduct of the trade or business. This proviso is satisfied when the employees and managers of the transferee conduct substantial operational and managerial activities in pursuit of the business. The law then articulates the role of independent contractors and "leased" personnel of related parties in this regard.
3. The transferee's active engagement in the trade or business must be outside the United States. Needless to say, the trade or business *itself* must be located outside the U.S. Otherwise, U.S. taxpayers could transfer appreciated assets abroad tax-free and subsequently continue operating a purely U.S. business through a foreign incorporated entity. Additionally, to prevent U.S. taxpayers from shifting gains outside the U.S. by executing circular transfers, this stipulation concomitantly requires the assets to remain outside the U.S. once transferred. Both requirements clearly subdue the income shifting potential of foreign incorporations.
4. The transferred property itself must be used (or held for use) in the trade or business. This statute is in line with the jurisprudentially developed business purpose concept. In order for the prescribed tax treatment to follow, this concept requires a sound business reason to motivate the transaction. Tax avoidance is not a sound business reason.

It is critical to note that the aforementioned outline is synoptic. The germane paragraphs of Treas. Reg. Sec. 1.367(a)-2T constantly articulate that each stipulation "must be determined under all the facts and circumstances." The law clearly prohibits a priori assumptions in this area and tax practitioners must perform their due diligence in each case.

It should be noted that IRC Sec. 367(a) only applies to gains. In other words, loss recognition is not allowed in any event (as stated in Treas. Reg. Sec. 1.367(a)-1T(b)(3)(ii)). As shown in the case of denying gain nonrecognition, it is useful to briefly consider the rationale for denying loss recognition on an outbound incorporating transfer. Consider that in the absence of loss nonrecognition, a U.S. taxpayer with a high income could selectively transfer only loss property in an outbound incorporation, thereby reducing its U.S. tax liability. Thus, Congress' principal objective in disallowing loss recognition is to prevent taxpayers from artificially reducing their U.S. tax liabilities by concluding potential loss stuffing transactions.

Exceptions to the Exception

Certain classes of assets embody key exceptions to the exception in the sense that the transfer of these assets triggers some sort of immediate gain (but not loss) recognition. This is irrespective of whether the active trade or business exception is satisfied or not. One important class of such assets includes "tainted assets" which are treated as having been sold by the transferor when transferred abroad. The resulting gain is capital or ordinary, depending on the asset's economic relation to the transferor. IRC Sec. 367 lists the following as tainted assets:

- Inventory
- Installment obligations and unrealized accounts receivable
- Foreign currency
- Intangibles
- Property leased by the transferor unless the transferee is the lessee

Note that each of these tainted assets present the transferor with opportunities to manipulate the international source of income rules. For example, anticipated U.S. source income from installment obligations, accounts receivables, or rental receipts from leasing personal properties would become reclassified as a foreign source merely by transferring ownership of the underlying assets to a foreign person. Similarly, transferring inventory to a foreign subsidiary enables a multinational enterprise to arrange the passage of

title in a sale to take place outside the U.S. Since a sale is deemed to take place where title passes (Treas. Reg. Sec. 1.861-7(c)), U.S. taxpayers could avoid U.S. taxation by siphoning income to a foreign tax jurisdiction through a foreign corporation. Realizing the potential for abuse afforded by tainted assets, Congress imposes the deemed sale rule onto the transferor. It should be mentioned that of all the aforementioned tainted assets, intangibles are separately taxed pursuant to special rules (IRC Sec. 367(d)).

Besides gain recognition on tainted assets, the law also requires that the recapture of certain previously claimed U.S. tax benefits to the extent gain is realized. While depreciable assets under IRC Sec. 1245 and 1250 yield the most common recapture potential, it should be mentioned that there are also certain industry-specific (mining, farming, oil & gas, etc.) benefits that are required to be recaptured. Note that unlike tainted assets, assets yielding previously claimed tax benefits are not deemed sold to the transferee in an IRC Sec. 367 transaction. Rather, the transferor is required to report the amounts of previously claimed U.S. tax benefits as ordinary income to the extent of realized gains—not recognized gains. This legal requirement of recapture therefore precludes taxpayers from enjoying a potential double tax benefit, such as transferring a previously depreciated U.S. situs asset in a foreign incorporation and consequently selling the then foreign situs asset free of U.S. depreciation recapture. Of course, there is no such recapture of previously claimed U.S. tax benefits in the case of transferred properties carrying realized losses. This is logical since IRC Sec. 367 does not apply to losses and this treatment is also consistent with domestic tax provisions addressing recapture.

Conclusion

The incorporation of a foreign business by a U.S. taxpayer implicates a plethora of U.S. tax laws designed to prevent tax avoidance. Ultimately the taxation—or tax deferral—of outbound incorporating transfers depends on underlying economic factors such as the nature, character, destination and income potential of the transferred assets. When serving a globally expanding business client, tax practitioners must diligently obtain all the relevant facts and circumstances when turning to the law for guidance. **EA**

About the Author:

Anthony "Tony" Malik, EA, is the principal consultant and owner of Point Square Consulting in Atlanta, Georgia. He specializes in representation and international taxation (individuals and businesses). Tony practices a wide range of multijurisdictional tax issues spanning across compliance, planning, and litigation. Tony enjoys answering tax questions from the EA community and can be reached at tony@pointsquaretax.com.

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