VENTURING OUT: INTERNATIONAL INCOME TAX PLANNING FOR SMALLER U.S. BUSINESSES

By Allen J. Littman[1]

Introduction

Have taxes on international transactions gotten too complicated for small business? It is almost an oxymoron that the rules in this area are not well understood by smaller companies and their managers, and compliance with rules that appear illogical and so vigorously resist understanding can be close to impossible. These rules consist of complex Internal Revenue Code (IRC) and Regulations, foreign statutes and regulations, tax agency rulings, cases, and tax treaties. None of these appear to be getting any simpler! Many of these rules have developed into complex regimes to provide or regulate tax benefits for large multinational corporations, which, of course, have large tax departments and ready access to sophisticated international tax advice.

This article offers a simple plain-language outline for business owners who are not tax experts to learn about the process and principles for planning to manage the taxation of their company's international operations. I will (i) describe a few basic planning paradigms, (ii) identify the key principles involved in basic international tax planning, and (iii) provide some examples of the operation of these principles in the U.S. tax law.

Basic International Planning Paradigms for Beginners

Let's say that you own or operate a small business that provides a product.[2] There are a number of ways that this may occur:

1. Manufacturing a product in the U.S. and selling it here;
2. Manufacturing a product in the U.S. and exporting it;
3. Manufacturing a product outside the U.S. and importing it for sale here;
4. Manufacturing a product outside the U.S. and selling it outside the U.S.; or
5. Some combination of the above.

With respect to items 3 and 4, the business may be contracting with a foreign manufacturer that utilizes your patent, design, method or other intellectual property (collectively, "IP") to manufacture to specifications. The IP may or may not be subject to legal protection.

As an example, suppose the business wishes to develop new foreign markets, to significantly increase sales of the product to current foreign customers, or to move (or

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[2] The discussion will focus more on products than services, but much of the discussion is also highly relevant to services.

increase) its manufacturing abroad. It could continue to manufacture the product in the U.S. for export, or could even manufacture the product abroad and import it into the U.S. for re-export, but transportation costs and logistical issues may make such plans impractical. In the context of developing foreign business, one of the key business drivers may be to move the product production process geographically closer to the foreign customer to reduce shipping and similar costs.

Would these difficulties be avoided if the business caused its U.S. operations to purchase the product produced abroad and drop ship it to foreign customers? Putting such a business structure into place may subject the U.S. operations to U.S. income taxes based on its gross margin even though the product in the example is not to be used or consumed in the United States. A major goal of international tax planning is to avoid adding unnecessary layers of U.S. or foreign taxes, in this case U.S. taxes on sales or manufacturing processes of products which are both produced and sold overseas. How can this be achieved?

Why Use Companies?

If a U.S. company purchases (or manufactures) goods overseas and imports and sells those goods in the U.S., it must pay U.S. tax on the difference between the sales price and the purchase price (or the full manufactured cost). Similarly, if a U.S. company purchases (or manufactures) goods in the U.S. and sells them for export, it must pay U.S. tax on the difference between the sales price and the purchase price (or the full manufactured cost). In either the import or export scenario, if goods are purchased from or sold to a commonly controlled legal entity, the transaction price must (in general) be the same as it would be if the parties were not commonly controlled. This concept is called "arm's length transfer pricing," and tax authorities everywhere are very interested in enforcing the extremely detailed transfer pricing rules they have created.[3] Isolating this potential tax issue is one tax reason for using separate legal entities.

The portion of the sales price attributable to a commonly controlled foreign company generally will not be included in the U.S. tax base until it is remitted (repatriated) to the U.S. This concept is called tax deferral. By the use of deferral, transfer pricing, and certain legal structures and elections, a large U.S. multinational company may defer payment of U.S. taxes on its foreign manufacturing profits, for example, by organizing and operating a foreign corporation to actually manufacture and sell its goods to customers, to certain related foreign companies, or to a U.S. operating company.[4] Other relatively complex structures may be put in place to defer the payment of U.S. tax on

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[3] In general, arm's length pricing must be documented and the documentation maintained by taxpayers. Such documentation is often prepared by economists due to its complexity.

[4] The term "transfer pricing" has also come to refer to the implementation of certain legal and commercial structures in order to legally minimize taxes. This latter concept of transfer pricing is much broader and far more complex than the traditionally narrower concept that focuses simply on "how much" was paid in a transaction between two related companies. The broader concept of transfer pricing typically aims to integrate complex entity structures and certain tax elections with income flows in order to legally place a certain amounts of profit beyond the reach of a particular tax authority.

foreign income in other situations or with respect to other types of income. However, a smaller business may not be ready to dive into running its own foreign manufacturing operation or to organize and maintain a very complex legal and operational structure.

The good news is that a smaller business may be able to obtain a similar tax "deferral" in less complex ways. For example, organizing an intermediate foreign distribution company may save U.S. taxes in some situations if the company also engages in certain activities in support of manufacturing. It is important, however, that the company be clear about its goals and its commitment to achieving its goals.

Two Critical Questions

For a smaller U.S. business considering the initiation or expansion of operations outside the United States, the following two critical tax decisions must be addressed early in the planning process:

1. In general, do you intend to repatriate your foreign profits back to the United States, or instead to reinvest them abroad (deferral)?

2. How much "substance" in terms of people and property are you willing and able to have situated outside the United States, and how soon?

The answer to the first question will determine certain key elements of the legal structure. The answer to the second question may expand or limit the planning options available.

The repatriation or deferral decision

In addressing the structuring options available for repatriation or deferral of foreign income, it is important to consider the current U.S. legal and tax structure of your operations. Simply put, the question is: what do you plan to do with your foreign profits?[5]

This decision is not very much different in the foreign context than in the purely domestic context. If business income that is generated by the U.S. business (or by the foreign operations) is to be distributed to shareholders currently or regularly, it may make sense to legally structure the U.S. business as a "pass-through" entity, such as a Subchapter S corporation or a U.S. LLC to ensure that there is only one level of U.S. tax imposed on the business and its investors as a whole. If, on the other hand, U.S. business income (or, again, foreign business income) is to be retained and reinvested in the U.S. business after payment of tax, it may be more tax effective to organize the U.S. business as a corporation. The tradeoff is that in a non-pass-through (corporate) structure, both the U.S. business and its shareholders are generally subject to their own tax. That is, there is a second level of tax on shareholders when the business income is distributed to them in the form of dividends. These two structures should generally be modeled quantitatively

[5] The economic decision of repatriation or deferral may depend on, for example, the maturity of the industry or simply the owners' financial wants or needs.

and the time value of money should be taken into account to determine the optimum tax strategy for a particular business or investment.

It should not be surprising that a similar decision must be made with regard to foreign operations and income. That is, foreign legal structures may be implemented through which income may be subject to immediate tax in the U.S., generally through the use of foreign pass-through companies, as described below. This approach may work well if, near the time it is earned, current income is to be distributed to the ultimate shareholders or for use or reinvestment in the U.S.

If, instead, the actual earnings are to be retained or accumulated in the foreign business or in a related foreign business, for example, for foreign reinvestment of those earnings, a complete pass-through structure is likely not desirable. The basic deferral rule is that income not brought back to the United States is not subject to U.S. tax, although there are some significant exceptions to this deferral principle (see the discussion below). If properly structured, income "flowing" up to a U.S. company through a foreign pass-through structure may be "stopped" by foreign company "stoppers" at any level in the foreign entity structure, including at the lowest foreign operating company level. A stopper is an entity that is not treated as a pass-through, so that income flows up to the entity but not automatically through it to its owner(s). A stopper itself may or may not be subject to foreign or U.S. tax, depending on the country in which it is organized, and in some cases, on the nature of the income in question. If properly structured, the use of a foreign stopper may permit the redirection of income or investment from one foreign entity or business to another without incurring U.S. tax.

This planning should be done in a manner that maintains the ability of the ultimate shareholders and intermediate companies to obtain and utilize credits for any foreign taxes imposed on the foreign operating companies. This may be particularly critical with respect to any shareholder who is an individual citizen or resident of the United States. In such a case, a non-pass-through structure or the use of foreign stoppers in the structure will likely prevent these individuals from ever crediting the underlying foreign taxes against their U.S. income taxes. If it is intended to repatriate all (or most) profits and distribute them to individual shareholders, and it is expected that foreign taxes will be significant, a complete pass-through structure should be considered in which both income and foreign taxes are accounted for by the ultimate shareholders.[6] U.S.-based corporations, however, may be able to credit foreign taxes that are paired with the related dividend income that arises upon the repatriation of income from foreign stoppers.[7]

The key points here are that (i) a decision must be made regarding repatriation versus deferral, (ii) a structure must carefully be put in place to implement that decision, and (iii) the availability of credits for foreign taxes should be carefully considered. The decision

[6] This should be balanced against the current concessionary 15 percent rate on dividends. Dividends received by U.S. individuals from certain foreign corporations may be eligible for this special rate, which is scheduled to expire after December 31, 2012 for calendar year taxpayers.
[7] Internal Revenue Code ("IRC") § 902. However, S corporations do not qualify for this benefit because they are treated not as corporations, but as partnerships for foreign tax credit purposes. See IRC § 1373(a).

depends on the needs of the business and its owners, the geographical expectations of future growth and the lifecycles of the relevant products.

Substance -- how much and how soon?

The practicality of putting a foreign legal structure into place to support foreign operations requires the willingness and ability to commit to the investment in both people and property. U.S. and foreign tax authorities may not accept mere "mailbox" companies as genuine and may ignore their legal entity status, with negative and unpredictable consequences. Many taxpayers in the foreign start-up or expansion mode attempt to give "substance" to new entities by hiring local service companies to perform certain administrative tasks, such as company registration, accounting, and accounts payable for the entities, and by contracting out operational tasks. This method may be successful for a period of time in some countries, but may ultimately fail as time goes by if a foreign entity does not develop its own substance and local tax authorities view it as not "real."

The establishment of local substance may require the investment in property (which may include leased property) and "true" employees – that is, not leased employees or contractors. On the other hand, it may be possible to share real company substance in a country with another company in the same location by entering into shared employee agreements or splitting payroll. It may be helpful to develop a foreign "hub" country where operations and substance may be developed. In addition, obtaining the benefit of certain special foreign tax incentives may require a specified or agreed level of substance for certain operations or functions that must be met by employees and/or property. This may represent a significant commitment in countries in which employees may not easily be terminated or working hours reduced. In any event, a plan, timetable, and, most importantly, a budget to inject genuine substance should be developed and put in place.

Many of the detailed U.S. tax rules in the IRC or Regulations are intended to ensure a certain level of local substance. Some of these are described below in the section entitled "U.S. International Tax Planning."

Foreign Tax Law – In General

Once the key U.S. taxation decisions of repatriation versus deferral and substance have been addressed, it is important to gain an understanding of the applicable tax laws in any foreign jurisdictions in which the organization will be operating or may establish a legal entity. Typically, an entity will be established in a country in which the organization will be operating, but that may not always be the case. Business, regulatory or tax considerations may make it more attractive to establish a local branch of an entity established elsewhere, or it may be possible and tax-effective to do business from an entity organized in another country. The form of the operations, as well as the substance, may determine local tax consequences in many foreign jurisdictions.

The most important elements of foreign tax law to consider are net income tax and any withholding taxes, which are ordinarily imposed as ancillary to net income taxes.[8] Net income taxes (i.e., net of business expenses) are usually applied to locally organized companies and branches. Withholding taxes are usually applied on a gross basis (i.e., without deduction for expenses) to interest, dividends and royalties paid by a locally resident company or branch to a nonresident company (or individual). Some countries (such as the U.S.) may impose both net income tax on corporations and withholding tax on dividends that it pays to nonresidents. Tax treaties generally reduce the rates of gross withholding taxes. In the case of net income tax, it is important to understand available deductions, including depreciation (or capital allowances), in sufficient detail to be able to model their effects quantitatively.

Although general outlines of the tax rules in many foreign countries are readily available in publications or online, or a U.S.-based tax expert may provide certain information, there is no substitute for obtaining advice from a local expert, typically an attorney or accountant with cross-border tax expertise.[9] There may also be tax incentives available for certain types of operations or locations. In doing so, however, it is important to ask the correct questions, with an eye to coordinating the advice and information received with the effects of U.S. tax law on the transactions and structure.

Tax treatment of foreign local income

It is, of course, important to learn the local tax rate, including the rates of any taxes imposed by political subdivisions. It may be also useful to identify any disparate treatment of different types of local income, for example, distribution or manufacturing income. Through legal structures or contracts, it may be possible to transform one type of income into another type that is economically equivalent but may be taxed differently, for example, sales income into commissions or royalties.[10]

Foreign taxes on cross-border income

It is also important to consider the cross-border taxation of the entity's operations. When income crosses a border, it is often taxed by the governments of one or both of the countries. Key cross-border issues include the ability to credit taxes imposed by foreign country A against taxes imposed by foreign country B or by the U.S.; whether the countries involved have territorial or worldwide taxation systems; and whether the benefits of an income tax treaty may be available. Sometimes cross-border transactions may be more lightly taxed than transactions that take place within a particular country. Consequently, as a business's international structure expands, it may actually attract less

[8] Although some planning is necessary to manage consumption taxes, particularly VAT, it will be assumed – as is ordinarily the case -- that the consumer will ultimately bear any applicable local VAT.
[9] Many find accountants helpful in this regard because they can assist in identifying the accounting requirements and in preparing formal entity financial statements that may be required to be used in preparing local tax returns.
[10] This type of planning and related economic analyses may also form the basis for more advanced transfer pricing planning.

overall foreign taxes.

Foreign holding companies: jurisdictional and tax treaty issues

Your business may also want to consider the use of foreign holding companies to collect profits and reinvest them abroad. These companies would generally be structured as foreign stoppers, but it also may make sense to utilize a pass-through entity as a holding company. The decision as to which jurisdiction is best to set up a foreign holding company may be one of convenience, based on where substance already exists (or is feasible), or may be determined by the nature of the operations and the nature of the income to be earned. It is not essential that the holding company be organized in a country geographically close to that of the operating company, but it may help to lend substance to the holding company, although, as a holding company, a very high level of substance may not be required. It is more important to carefully consider what holding company benefits would be most beneficial to the taxation of your business operations. Some jurisdictions have very favorable taxation for one type of income versus another. For instance, the Netherlands and Luxembourg are known for being favorable jurisdictions for centralizing financing and IP operations.[11]

With regard to the countries in which the holding company is organized and the countries in which the companies owned by the holding companies are organized or operating, it is important to consider how the tax rules and tax treaties of those countries may affect flows of capital, income and cash. In particular, minimizing foreign withholding taxes through the use of tax treaties should be carefully considered. It is helpful to understand that most (but not all) foreign tax treaties that do not involve the U.S. do not contain "limitation on benefits" rules, which are typically used to prevent treaty shopping. Treaty shopping rules typically require the examination of the ownership of the company claiming treaty benefits (typically the recipient of a payment subject to reduced treaty withholding) in order to evaluate its level of local substance and whether its owners chose to organize it in that country in order to obtain the benefits of that treaty. It is important to consider these issues in some depth, because these rules may often be highly technical rather than intuitive. The same may be true of a tax treaty, if any, between the U.S. and the country in which the holding company is organized.

Tailoring tax planning to business operations

Perhaps the most important element in effective tax planning for companies that operate an international business is to tailor the planning to the operational, IP, distribution and manufacturing requirements and attributes of the enterprise. Once there is a general structure in mind and the operations countries have been identified, the next step is to consider alternative structures involving holding companies and potential legal

[11] Essentially, these countries have IP regimes where certain items such as patents may be more lightly taxed, and they have a large treaty network which may eliminate or minimize tax withholding on royalties or interest. Luxembourg also has created special cross-border financing instruments with favorable characteristics. On the other side of the world, Singapore and Hong Kong are often used as holding jurisdictions for financing, operational holding companies, or joint ventures.

relationships, both ownership and contractual, between the operational companies, any holding company, and the main U.S. company (or companies), considering the decision regarding deferral versus repatriation.

U.S. International Tax Planning

This section will address the U.S. tax issues that overlay these types of foreign legal entity structures. If the plan is to repatriate all of the income back to the United States and a pass-through structure is implemented, the U.S. issues will be relatively simple. On the other hand, if deferral is desirable, then the business must plan to avoid the U.S. anti-deferral rules of "subpart F" of the IRC.[12] For example, assume that the business makes and sells a product abroad through a group of foreign corporations, and wishes to defer U.S. tax on its foreign income. The subpart F rules operate to immediately impute certain types of foreign income to its U.S. owners when that income is earned. These rules apply to income earned by a "controlled foreign corporation" (CFC). A foreign corporation is a CFC if over 50 percent of its voting stock or its total value is owned, directly, indirectly or constructively (i.e., through related parties according to specific attributions rules) by U.S. citizens, U.S. residents, or U.S. corporations or partnerships, each of which owns (again, directly, indirectly or constructively) 10 percent or more of the voting stock of the foreign corporation.[13]

In the case of a CFC, subpart F income consists generally of certain income classified as "passive" and certain specific types of active business income. As alluded earlier, avoiding subpart F classification for active income mainly requires the creation and maintenance of certain levels of substance. Some of these rules include very specific requirements.

Passive income

Passive income comprises income such as rents, royalties, interest, dividends and sales of the stock of other corporations.[14] There are a number of important exceptions to these rules, some specific to particular subtypes of income. For example, there is an exception for payments of dividends, interest, rents and royalties from one CFC to a related CFC[15] if the payment is not attributable to subpart F income of the payor.[16] However, this exception expired for taxable years of foreign corporations that begin in 2012.[17] Exceptions for certain "active" rentals and royalties are discussed below.

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[12] The subpart F rules are found in IRC §§ 951-965.
[13] IRC §§ 957(a) & 958. For example, a foreign corporation owned 50-50 by two unrelated shareholders is not a CFC unless both interests are directly, indirectly or constructively owned by U.S. persons described in the text above.
[14] IRC § 954(c)(1).
[15] A person (including another CFC) is related to a CFC if it controls it, is controlled by it, or if it and the CFC are commonly controlled. Control in this context means ownership directly or indirectly of over 50 percent by vote or by value. IRC § 954(d)(3).
[16] IRC § 954(c)(6).
[17] It is possible that this exception may be renewed, perhaps retroactively.

Sales income

If the business sells a product and has a deferral strategy, it is important to avoid the category of subpart F sales income. This category consists of income derived in connection with sales of goods that are purchased from or on behalf of a related person, or are sold to or on behalf of a related person.[18] This type of income may arise, for example, where a CFC acts as a middleman distributor. The three key exceptions to this rule are (i) if the property is "manufactured" anywhere by the CFC, (ii) if the property is manufactured by anyone within the CFC's country of legal organization, or (iii) if the property is sold for use or consumption within the CFC's country of legal organization.[19]

The first exception listed above is the broadest and has attracted much controversy from the IRS over many years, in part due to companies attempting to meet the exception through the use of unrelated or related contract manufacturers. The IRS finally gave in approximately ten years ago and prescribed detailed guidelines for meeting this exception, including through the use of contract manufacturers. As a threshold matter, the process must first qualify as "manufacturing," which consists of either (a) the substantial transformation of property,[20] or (b) the assembly of component parts into the final product involving activities that are substantial in nature and generally considered to constitute manufacturing.[21]

In general, the CFC must satisfy the definition of manufacturing through the activities of its employees.[22] However, the CFC may meet the definition and be deemed to be manufacturing if its employees make a "substantial contribution" to the manufacturing through their activities, even if most of the processes are performed by a contract manufacturer, as long as the process as a whole also constitutes manufacturing under (a) or (b) above.[23] The types of activities that may be considered in making the determination of substantial contribution include (but are not limited to) the following:

(1) oversight and direction of the manufacturing activities or processes;
(2) selection of materials, selection of vendors, or control of the raw materials, work-in-process or finished goods inventories;
(3) management of manufacturing costs, including managing risk of loss, cost reduction or efficiency initiatives, demand planning, production scheduling, or hedging raw materials costs;
(4) control of manufacturing-related logistics;
(5) quality control;

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[18] IRC § 954(d)(1).
[19] Treas. Reg. § 1.954-3(a).
[20] Treas. Reg. § 1.954-3(a)(4)(ii). Examples given in the regulations are the transformation of wood pulp to paper, steel rods to screws and bolts, and tuna fish to canned tuna fish.
[21] Treas. Reg. § 1.954-3(a)(4)(iii). *See, e.g., Bausch & Lomb Inc.,* TC Memo 1996-57 (assembled sunglasses deemed manufactured). A safe harbor for this exception exists if direct labor and factory burden account for 20 percent or more of the total cost of goods sold. However, packaging and "minor assembly operations" do not qualify for this exception.
[22] Treas. Reg. § 1.954-3(a)(4)(i).
[23] Treas. Reg. § 1.954-3(a)(4)(iv)(*a*).

(6) developing or directing the use of manufacturing- related IP, including product design, and design specifications, trade secrets and technology; and
(7) activities such as minor transformation or minor assembly, which by themselves are insufficient to meet the definition of manufacturing.[24]

No particular type of listed activity is required, and, in general, the importance of the contribution items is weighed by reference to their relative importance in the manufacturing process. For example, suppose that CFC-A, organized in Country A, purchases products manufactured by an unrelated contract manufacturer, and then resells them to related CFC-B (organized in Country B) for sale to the end customer in Country B. CFC-A's income is subpart F income unless it is making a substantial contribution to the manufacturing process. However, if CFC-A purchases the products from the unrelated contract manufacturer and resells directly to unrelated end customers, it would not have subpart F sales income regardless of its participation in the manufacturing process. The first scenario is more common because the group generally attempts to get close to the end customer and it may be more tax effective for CFC-A to be located in a relatively low-tax jurisdiction. Note that CFC-B meets the exception of sale for local use or consumption ((iii), above).

Ultimately, a substantial commitment and investment of human resources is needed to use a company's employees effectively from a business perspective in order to take advantage of the substantial contribution analysis. Because it is a flexible analysis, it is dependent on the particular facts of how the product is produced and the activities performed by the CFC related to its manufacturing. To be taken into account for purposes of the substantial contribution "substance" test, these activities generally must be performed by employees of the CFC (and not by contractors); thus, it must dovetail with the business model.

Rental income

Another example of the requirement of "substance" to avoid subpart F anti-deferral rules is in the area of so-called "active" rents and royalties, that is, rents and royalties derived by a CFC in the active conduct of its trade or business. These types of income may be exempted from subpart F when received from an unrelated person.[25] Treasury Regulations specify detailed rules for qualifying these rents and royalties. For example, a CFC's income from the rental of tangible property qualifies for this exception if (i) the property was manufactured (see discussion above) by the CFC (but only if the CFC is regularly engaged in the manufacture of that kind of property),[26] or (ii) the CFC operates an organization in a foreign country that is regularly engaged in the business of marketing (which may include servicing) the property and that business is substantial in relation to the amount of rents derived from leasing the property.[27] Although what is "substantial" in such a case is determined based on the facts and circumstances, the business will be

[24] Treas. Reg. § 1.954-3(a)(4)(iv)(*b*).
[25] IRC § 954(c)(2)(A).
[26] Treas. Reg. § 1.954-2(c)(1)(i).
[27] Treas. Reg. § 1.954-2(c)(1)(iv).

considered substantial if the CFC's "active leasing expenses" equal or exceed 25 percent of its "adjusted leasing profit."[28] Parallel rules apply to active royalties.[29]

Services income

As a final example of local substance, consider foreign services income. A CFC's income from services is subpart F income only in limited circumstances. In general, income from services is considered to be subpart F income if the services are performed by the CFC for a related person outside the CFC's country of legal organization.[30] This rule applies if the U.S. parent company has entered into a third party service contract and the CFC assists in fulfilling the contract outside its country of organization. The rule also applies if the CFC has entered into a third party service contract and the costs of assistance of the U.S. parent and other related U.S. companies in fulfilling the contract comprise 80 percent or more of the total costs to the CFC of performing the services.[31] Thus, adverse U.S. tax treatment may be more likely to occur in the case of a smaller enterprise with only one CFC (or a small number of CFCs) that assists the U.S. company or that relies on the U.S. company for support in fulfilling its contractual obligations. This is another example of how the lack of substance – here, the CFC's inability to fulfill the contract without predominant support from the U.S. -- may give rise to detrimental U.S. tax effects.

Pulling it All Together and Venturing Out

Once the types of issues described above have been addressed, the pieces must be put together. These pieces are the understanding of the company's operations, goals and objectives, the repatriation/deferral decision and the willingness to inject employees and property into the venture, the proposed locations of its significant operations, the foreign tax rules that are applicable to these locations, and the overlay of the complex U.S. tax rules. The next logical step is to analyze the tax effects of potential legal structures and income flows across these dimensions and (to the extent possible) to further tweak the structures, activities, and tax elections to improve tax effectiveness. It is very important to quantitatively measure tax effectiveness up-front by modeling the taxation based on budgeted or estimated amounts in order that the costs (including the expected costs of developing local country substance required to achieve the tax benefits) and tax benefits of the plan may be compared.

What I have described in this article are the beginning steps for international tax planning for a relatively small U.S. company seeking to improve its international business in a tax-effective manner. Although there is much more to the international tax planning process, and many more advanced steps that may be considered, including international mergers and acquisitions and giving careful consideration to the tax-effective international development of IP, these are the basic building blocks for a smaller business considering

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[28] Treas. Reg. § 1.954-2(c)(2) defines these terms in detail.
[29] Treas. Reg. § 1.954-2(d).
[30] IRC § 954(e).
[31] IRS Notice 2007-13, 2007-5 IRB 410.

venturing out or expanding outside of the United States.

Key Takeaways

- **Decide in advance whether the company plans to repatriate its foreign income back to the U.S. or to defer it to grow the foreign part of the business.**
- **Develop a plan for how and when to inject genuine substance – i.e., employees and property, into its foreign operations.**
- **Obtain information regarding the tax rules in foreign countries from a local expert.**
- **One of the keys to effective international tax planning is to avoid unwanted subpart F income. Obtaining tax deferral for distribution activities while using a contract manufacturer should be explored.**
- **Quantitatively model the company's foreign operations tax plan and perform a cost-benefit analysis.**