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FOREIGN TAX CREDITS & VARIOUS OPERATING STRUCTURES

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For U.S. companies undergoing international expansion, there are a number of important issues to consider prior to commencing operations in a foreign jurisdiction. A principal consideration is the type of foreign entity through which the U.S. company will be conducting its activities in foreign markets, as this could materially affect overall taxation.

Direct Foreign Tax Credit

In general, foreign income taxes are imposed on business activities conducted in foreign jurisdictions. Where the U.S. company does not have a foreign subsidiary corporation set up, the U.S. company is directly responsible for any tax liability arising in such country. As such, the U.S. company will pay the foreign income tax directly and either (1) receive a foreign tax credit against its U.S. federal income tax liability assessed on such foreign source income, or (2) claim it as a business deduction. Usually, it is more advantageous for taxpayers to claim a foreign tax credit as it reduces the U.S. federal income tax liability, dollar-for-dollar. The total amount of foreign tax credit allowed is limited to the U.S. federal income tax liability on the foreign source income earned.

In the case of a U.S. company classified as a pass-through entity for U.S. tax purposes, such as a partnership, the partners of the partnership would claim a credit for their distributive share of the foreign taxes paid directly by the partnership. This would also be the case if the partnership were operating in the foreign country through a foreign entity that is disregarded for U.S. income tax purposes or considered a pass-through for U.S. federal income tax purposes. A foreign legal entity may be treated as a U.S. partnership or disregarded entity ("pass-through") for U.S. income tax purposes by making an election with the Internal Revenue Service. Generally, certain foreign entities, such as a "Sociedad Anónima", are not eligible to be treated as a pass-through entity under U.S. tax law. However, a Sociedad de "Responsibilidad Limitada" can be so treated.

Indirect Foreign Tax Credit

In general, a U.S. company classified as a C corporation that owns 10% or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year will be deemed to have paid the same proportion of such foreign corporation's foreign income taxes, otherwise known as "indirect (or deemed paid) foreign tax credits". In the case of a U.S. parent partnership, indirect foreign tax credits are not available since partnerships are pass-through entities. As such, where a partnership owns 100% of the voting stock of a foreign corporation, the 10% ownership requirement mentioned above would be met. However, the partnership would not be able to claim any indirect foreign tax credits for foreign taxes paid by its foreign corporate subsidiary since the U.S. parent is not a C corporation.

Ordinary vs. Qualified Dividends

Generally, dividend distributions are included in the U.S. shareholder recipient's gross income and subject to U.S. tax. Dividends are generally characterized as either a qualified dividend or an ordinary dividend. A qualified dividend is a distribution of cash or property made from either a U.S. corporation or a "qualified foreign corporation". A "qualified foreign corporation" is generally defined as a corporation organized in a treaty partner country eligible for benefits under such treaty. Qualified dividends are taxed at preferential rates which could be as high as 23.8% (i.e., 20% capital gains rate plus 3.8% net investment income tax) while ordinary dividends are taxed at ordinary rates, which could be as high as 37% , plus 3.8% investment income tax.

Generally, where the foreign country's income tax rate is lower than 21% and such jurisdiction is a treaty partner of the U.S., it is more advantageous to set up a foreign corporate subsidiary since dividend income recognized by a U.S. shareholder would be taxed at favorable qualified dividend rates. However, since the foreign country's income tax rate is higher than 21%, it is more tax efficient to structure the foreign operations using a disregarded / pass-through entity if profits are regularly repatriated since any foreign income tax paid can be taken as a direct foreign tax credit by the U.S. individual shareholder. Most Latin American countries have corporate income tax rates in excess of 21% (certain territorial tax jurisdictions not withstanding). As a result, structuring a Latin American subsidiary as a pass-through entity typically provides the most favorable U.S. tax result.

In light of the above discussion, the tax classification of foreign entities for U.S. federal income tax purposes is a significant aspect of any expansion plan that should be considered in conjunction with the foreign income tax rate to determine the optimal means of structuring a U.S. company's operations abroad.