

Tax planning, lower costs draw companies offshore

Done right, going global can generate a windfall

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Going global requires an appreciation of the risks involved, said Darice Henritze, discussing tax issues at the KPMG-UCD Global Enterprise Institute conference.

"You need to understand the risks of operating abroad from the beginning if your business is to thrive," said Henritze. "That means understanding the political environment and complying with the rules and regulations of the foreign jurisdiction." Failure to go global without preparation "could be a death knell for your company."

At the same time, no matter where in the world you are doing business, the United States maintains an interest in how you are operating and whether or not you are in compliance with a multitude of US laws and regulations. These usually involve taxes but can also be about legal issues such as the Foreign Corrupt Practices Act which makes it a criminal offense to participate in a bribe even though it may be an accepted practice in some countries.

"And you have to understand the real tax risks of what you are getting into."

The risks should not deter anyone from branching out, because "with the right planning, going global can generate a windfall for your company."

Can a company that's merely selling

globally be considered a global organization?

"You're global the second you access a customer in a foreign jurisdiction," said Henritze. "And that jurisdiction is going to have taxes and rules intended to draw some of your revenues into their country."

Tax liabilities

There are many methods for selling your product abroad, each with its own set of risks that can be mitigated with knowledge and planning beforehand. Henritze described the seven-level distribution hierarchy, starting at the top:

- Local to local
- Buy-sell (full-function) distributor
- Limited risk distributor
- Commissionaire (civil law agent)
- Agent
- Marketing representative
- Direct sale

There are tax risks at each level, even at the bottom—direct sale—where there is usually no face-to-face contact. The order is received on the company's website and shipped direct to the customer in some far-off country from the United States.

Is there a tax on that order?

"If you are a software company and your customer is a resident of the European Union, that order is subject to a value added tax (VAT) of 17 to 24 percent depending on the country."

Companies that are not aware of this and do not pay the tax run the risk of being assessed 20 percent of their software sales going back to the first sale. This can become a costly problem when ascending to higher levels of the distribution hierarchy and compliance regulations expose the oversight.

"I've seen numerous startup software organizations go global with direct sales via their website. Because they did not have a presence in the destination country, they did not realize sales were subject to VAT until

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they got ready to climb to the second level (marketing representative)," said Henritze.

"In one such case, the VAT people suddenly appeared and claimed the company sold \$2 million worth of software in the country for which VAT was not collected. Consequently, the company owed 20 percent of the \$2 million or \$400,000."

Henritze explained a concept called "permanent establishment" that in the distribution hierarchy affects marketing representative, agent and commissionaire.

"The rule says that if you have an independent rep completely unrelated to the company but with the authority to negotiate and sign contracts that bind you or to negotiate pricing terms, you are subject to tax on the income from those orders in both the United States and the foreign jurisdiction.

Zero tax rate

Countries that want your business often lay out the welcome mat in the form of tax incentives. "They will give you a zero tax rate for 10 years or they'll give you a 7 percent tax rate forever," said Henritze. "By moving operations into these foreign jurisdictions you might get your effective tax rate down to 22-23 percent whereas if you just did business in the United States, your effective tax rate might be 45-55 percent."

But to reap this benefit, "you have to be able to tell the IRS that you intend to keep that money offshore and not bring it back to the US."

Not a problem unless you have debt or other costs that have to be paid in the US. "You could get yourself in trouble because your cash cow is in another country and if you try to bring the cash back to the US it's going to cause your effective tax rate to jump up to that 45-55 percent bracket."

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Tax planning is not the only reason companies go offshore, said Henritze. "It's also to lower costs. In a place like China you can manufacture for 20 percent of what it would cost to manufacture in the US."

Henritze pointed out that over the last 10 years, hundreds of US companies set up manufacturing operations in China. "They received tremendous incentives in the form of long term reduced taxes, exemptions from export taxes and custom duties, and other benefits."

But what the government gives the government can take away. "About six months ago, the Chinese government said, 'We've got enough manufacturing in China. We've decided to get rid of all these tax incentives.'

"So all the companies that moved into China because they could get a 10-year tax holiday and relief from export taxes are all of a sudden paying a significant income tax and 100 percent export taxes. And they're stuck there; they can't get back out without tremendous cost."

Henritze foresees other countries following China's lead. "In the situation that we're in right now, where the economy is troubled in the United States, I do believe there will be a trickle down effect around the world. More countries, especially socialist nations, will take away some of the incentives they've been granting so they can generate more revenue and keep the government operating."

Two lessons:

- Make sure you understand the political environment because the government that gave you tax incentives yesterday can change its mind tomorrow.

- Do the negotiations before you show up because once you're there it's too late; they won't give you anything.

While it's still very cheap to manufacture in China, the question is how long will it stay cheap given the upward pressure on wages and the cost of living? "Fifteen years from now, China's cost structure may be very close to what it is today in the United States," Henritze said.

Evaluate trends, she said, and "ask yourself if the reason for choosing a particular country will be as valid in 10 years as it is today."

Manufacturing hierarchy

There are three tiers in the manufacturing hierarchy, each with its own set of risks and benefits.

Tier 1: Buy-sell manufacturer - a com-

bined manufacturer-distributor that has better access to markets, some tax benefits, and greater control of the manufacturing process. "The company might actually own the factory and be able to push profits into a low tax jurisdiction. All the risks fall to the company including product, safety, market, credit and all other business risks."

Tier 2: Contract manufacturer - a manufacturing services provider that has very limited inventory risk and no credit risk as it is separated from sales and marketing functions. "On the benefit side, the company contracting with the manufacturer does not have to invest in building or buying a factory. Control over the finished product is much less at this level though the company might employ an oversight person to ensure quality."

Tier 3: Consignment manufacturer - a manufacturing services provider similar to a contract manufacturer with one major difference. "The company consigns all raw materials to the manufacturer who has no inventory, credit, warranty or other risks. Although there is less control and greater risk in all departments, benefits also are smaller."

Tax issues generally include a combination of the following: transfer pricing, VAT, customs, currency & finance, expatriate tax issues, US Commerce Department reporting, local incentive negotiations, foreign exchange controls, withholding taxes, treaty issues, and/or local compliance and tax issues.

Then there's Subpart F, a tax levied by the IRS on foreign-source unearned income whether or not that income is remitted to the US. Subpart F is applicable at Tiers 1 and 2 but not at Tier 3.

Henritze stressed the importance of understanding the complexities of manufacturing in foreign jurisdictions and how they apply to laws there and in the US.

Your money, their way

Once invested in a country, you may find that the government had less restrictions on the money you brought in than on the money you will want to take out at some point.

"Most governments that give you an incentive will require that you negotiate a minimum amount of capital infusion into their country. And once you infuse that amount they probably will not let you take it back out. You have to keep it at that level or keep it growing." Henritze cited two countries in particular that make it difficult

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to repatriate profits on the investment.

"In countries like Brazil and China, you may be generating a tremendous amount of revenue but it may be trapped there. This could be a problem when you have debt that has to be serviced back in the United States.

"If you don't understand what the restrictions are in getting your cash back into the US, you may put your company in a precarious position," said Henritze.

A few more things to think about.

Foreign exchange controls. Companies doing business globally also have to be aware of foreign exchange controls. "As a result of what happened on 9/11, the US government is now very, very interested in where you have your money. The US Department of Commerce will impose a hefty fine — as much as \$100,000 — if you fail to tell them you have control over a bank account in a foreign jurisdiction."

Income taxes. "When you go offshore, the type of income taxes that can cause unpleasant surprises are not just on passive types of income such as interest, dividends and royalties earned by your offshore entity. Income becomes taxable when your offshore entity buys product from a contract manufacturing facility you've set up in China or some other country and then resells it elsewhere in the world.

"There are a set of rules that view this as shifting income because you bought from a related part of your operation and shifted income outside of that contract manufacturer's jurisdiction. All that income will be taxed when it's brought into the US," said Henritze.

"These and other rules are intended to speed up the time at which you can get taxed in the US. The foreign rules are intended to shift as much income as possible into the foreign jurisdiction. So you've got everybody fighting for your tax dollar. You've got to be really careful.

"I would emphasize that it's not income taxes but indirect taxes which tend to cost companies the most money," said Henritze. "Because indirect taxes are taxes on gross not on net." ♦