Practical US/International
Tax Strategies

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More Bang for Your Buck on Supply Chain Improvement Programs

BY SALLY CHESHIRE
(DELOITTE & TOUCHE)

This article explains the value of optimizing supply chains through tax-efficient restructuring.

In a bid to secure competitive advantage, we are all striving to lower our cost base and improve bottom line performance. Streamlining supply chain systems and processes can deliver a vital combination of reduced stock levels and lead-times, reduced WIP, better asset utilization, improved use of production sites, increased productivity, and superior service to customers.

However, what if the financial benefit of these initiatives could be improved long-term? By limiting your field of vision to operations alone, you could be missing a trick -- the smart companies are leveraging their supply chains through integrated tax planning and proactively managing a business cost that is often ignored.

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Globalization: the US Tax Code and its Impediments to Global Trading

Pending Legislative Changes

BY STEPHEN MALLEY

This article considers a number of recent trends and developments in international trade and taxation, which are affecting the competitiveness of US-based multinationals.

Globalization is a hard reality for today's businesses. Cost and price pressures send manufacturers looking worldwide for the lowest costs commensurate with quality requirements, and cross-border purchases and sales are the norm for even small businesses. One can appreciate the impact of the global economy by noting that Southern California's trade with China alone exceeded $55.5 billion in 2002.

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Global Trade Competition

The European Union ("EU") is a burgeoning economic powerhouse, although its growth has slowed currently. The EU's mandate is to eliminate trade barriers among its member states and to enforce compliance primarily through the EU treaty. Article 49 of the treaty provides that ". . . restrictions on freedom to provide services within the Community shall be prohibited," and Article 56 confirms that ". . . restrictions on the movement of capital between member states shall be prohibited."

The EU offers businesses, including US businesses, the opportunity to manufacture in, and sell to, EU member states without the impediments of duties and tariffs (taxes are a different issue), and to manufacture to an essentially single standard of quality or conformance.

The EU offers businesses, including US businesses, the opportunity to manufacture in, and sell to, EU member states without the impediments of duties and tariffs (taxes are a different issue), and to manufacture to an essentially single standard of quality or conformance. (It should be noted that some EU countries continue to impose trade barriers, often in the form of tax disincentives.) *See*, *e.g.*, "Discriminatory Tax Barriers Facing the EU Funds Industry," by PricewaterhouseCoopers.

However, US companies remain at a competitive global disadvantage under the US tax code, which may be the reason why only eight of the world's 20 largest corporations are now headquartered in the US -- down from 18 in 1960. Although the US is commonly recognized as the world's largest economy, almost 80 percent of the world's purchasing power and income is now derived from sources outside the US. The dollar is currently at its lowest level

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PRACTICAL US/INTERNATIONAL TAX STRATEGIES

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Compliance Alert

An Unwelcome Surprise

Potentially Greater US Tax Exposure for Financially-Troubled Companies

BY KEITH MARTIN
(CHADBOURNE & PARKE)

US multinationals with uncovered pension liabilities could face an added US tax burden. This article explains the risk.

Financially-troubled companies may be getting an unwelcome surprise.

US multinational corporations that own assets in other countries usually do so through offshore holding companies. Many of those holding companies are located in Holland, Bermuda, the Cayman Islands, or other similar jurisdictions.

US multinationals do this to avoid having to pay US taxes immediately on their earnings from abroad. US taxes can be deferred until the earnings are repatriated back to the United States. The companies must be careful in the meantime not to make indirect use of the earnings in the US because this would trigger an immediate US tax.

An example of indirect use, which would expose the US companies to US tax, is where a US parent company borrows money and pledges the assets of its offshore holding company as security for the loan.

Unfunded Pension Liabilities

Financially-troubled US companies that have fallen behind on their contributions to employee pension plans are now in for a rather unwelcome surprise. A lien arises automatically against, not only the US company, but also the assets of all offshore companies that are part of its "controlled group," in favor of a federal agency called the Pension Benefit Guaranty Corporation ("PBGC") if the US company fails to satisfy minimum funding requirements for its qualified retirement plans.

This sudden "debt" to the PBGC -- secured by the assets of the US companies' offshore holding companies -- could trigger immediate taxes for the US companies on any unrepatriated earnings in their offshore holding companies up to the amount of the liens they have incurred.

Some US parent companies might have no choice other than to file for bankruptcy -- not only for themselves, but also for their offshore holding companies -- to avoid the additional US tax liabilities. A bankruptcy filing gives rise to an automatic stay against the enforcement or perfection of a lien by the PBGC.

In these circumstances, a US parent company might have no choice other than to file for bankruptcy -- not only for itself, but also for its offshore holding company -- to avoid the US tax liability. A bankruptcy filing will give rise to an automatic stay against the enforcement or perfection of the lien by the PBGC. ❑

Practical US/International Tax Strategies wishes to thank Keith Martin of Chadbourne and Parke LLP for contributing this piece to this issue of our publication. Mr. Martin has been a tax partner in the Washington office of Chadbourne and Parke since 1983. He is a valued member of the Advisory Board of Practical US/International Tax Strategies. Keith can be contacted by email at kmartin@chadbourne.com.

***Supply Chains* from page 1**

A reduction in taxation levels can have a substantial impact on the P&L, and fast. A manufacturer with a turnover of £500m and seven manufacturing sites could typically expect to save in the region of £10m annually in tax efficiencies by appropriately structuring manufacturing, distribution, and sales functions. Imagine the amount of supply chain streamlining you would have to do to realize similar results through cost reduction projects or revenue generation initiatives alone.

The smart companies are leveraging their supply chains through integrated tax planning and proactively managing a business cost that is often ignored.

Optimizing your supply chain through tax-efficient restructuring means designing business processes that are both operationally and tax efficient. The critical success factor is ensuring that the tax opportunities presented by a supply chain project are identified at an early stage and developed as an integral part of the project, and that the tax team pinpoint and plan around any possible tax risks that may arise.

The Benefits: One Plus One Equals Four . . . ?

An optimized supply chain can reduce operating costs by up to 20 percent, with benefits derived from:

- the standardization of processes across sites to allow for the sharing of best practices;
- more efficient performance;
- more effective control;
- a lower cost base, creating a significant source of competitive advantage;
- the introduction of shared services;
- the harmonization of systems across sites to facilitate consistent data standards for financial and management reporting.

Likewise, tax-integrated projects can expect to shave significant amounts off your corporate tax liabilities. So why not create synergies by linking together the two concepts? By harnessing the combined knowledge of tax planners and supply chain experts, incremental savings can be realized, which are significantly higher than the aggregate of the individual projects.

The supply chain processes adopted by a business will depend upon its structure and strategy. Likewise, the optimum tax structuring needs to be tailored to the organization. However, it is not a huge departure to align the new business process model to an optimized tax structure, giving consideration to VAT issues and transfer pricing, and identifying the key drivers affecting profitability including purchasing, sales, manufacturing, and logistics.

Your objective must be to balance the tax requirements with the commercial needs of the business, achieving statutory and fiscal compliance, while minimizing the impact on day to day operations. To deliver the tax benefits, a degree of centralized control and risk management must be demonstrated -- however, smart restructuring will avoid the need for a large-scale relocation of people.

In any case, central visibility is a key component of an optimized supply chain, giving enhanced planning capability across the network.

A Case Study

A global manufacturer of engineered products operates seven production sites and sells through a global network of sales affiliates. Under the new tax-efficient structure, the management function (principal) is located in Ireland, and controls all aspects of the supply chain, including sourcing and purchasing, demand planning, distribution, and quality assurance.

Services such as warehousing, marketing, and research and development are provided locally under "service level agreements" between the local sites and the principal.

The activities of each party were defined in the new model and priced accordingly. Major trading risks are now assumed by the Irish principal and, as such, the majority of the profit will arise in that entity.

The tax structure supports the commercial needs of the business and the profit generated will benefit from the low Irish tax rate, with an anticipated savings of £6m per annum.

Undoubtedly, this is a major program of work, but the returns are greater than a supply chain project alone can deliver. The tax efficiencies can also make your investment pay back rapidly allowing you to justify additional improvement projects, which you could not otherwise afford to undertake, and thereby further enhancing the long-term competitive advantage.

Would it Work for Us?

A tax-efficient supply chain may be a significant opportunity for your organization if one or more of the following applies:

- your operations span several countries;
- you have a complex supply chain (*e.g.*, multi-product, multiple manufacturing sites);
- you have an annual turnover of more than £100m across the territories in scope;
- your organization is in profit -- if you are not generating profit, the losses will be incurred in a low-tax jurisdiction;
- you feel your organization would benefit from a supply chain restructuring, process improvement program, or a management information system upgrade -- in other words, the supply chain has yet to be optimally conceived.

Can You Afford to Overlook this Opportunity?

A combined supply chain and tax redesign can result in:

- a more efficient business;
- a tax structure that maximizes the financial returns of the commercial reorganization; and

It is not a huge departure to align the new business process model to an optimized tax structure, giving consideration to VAT issues and transfer pricing, and identifying the key drivers affecting profitability including purchasing, sales, manufacturing, and logistics.

- rapid payback, making the project self-funding.

If this has whet your appetite for change, then it may be time to talk to your tax colleagues. ❑

For more information about tax-efficient supply chains, please contact the author of this article, Sally Cheshire. Ms. Cheshire is a Director in Deloitte & Touche's UK consulting practice, leading the firm's pan-European consulting work in the tax-efficient supply chain area, liasing closely with European and US tax colleagues to ensure that these engagements are managed efficiently and cost effectively for the firm's clients. Ms. Cheshire can be contacted by telephone at 0161-455-6909, or by email at schesire@deloitte.co.uk.

Hedge Fund Investments May Be Challenged

Offshore Insurance Companies' Investments Subject to IRS Scrutiny

BY DAVID COOPER
(PRACTICAL US/INTERNATIONAL TAX STRATEGIES)

This article focuses on the US tax treatment of certain investment vehicles with foreign components. Specifically, it looks at the federal government's plans to challenge structures involving offshore insurance companies that invest in hedge funds or "hedge fund-type" investments.

The Internal Revenue Service might deny certain tax benefits generated by arrangements involving offshore insurance companies that invest in hedge funds or that make the types of investments hedge funds usually make.

In certain circumstances, the US Treasury Department and the IRS will take the position that risks assumed under the contracts issued by certain foreign corporations might not be insurance risks. The government also might argue that the terms of the contracts significantly limit the risks assumed by the foreign corporation in question.

With Notice 2003-34, 2003-23 I.R.B. 990 (June 9, 2003), the IRS has issued a three-part challenge to these arrangements, taking the position that: (1) they might not qualify as insurance; (2) the entities involved might not qualify as insurance companies; and (3) stakeholders (*i.e.*, investors) could be subject to the US passive foreign investment company ("PFIC") regime under the Internal Revenue Code. Basically, the IRS will challenge these transactions whenever it deems it would be appropriate to do so.

In Notice 2003-34, the US Treasury Department and the IRS have said that they are now aware of certain arrangements taxpayers are using to defer the recognition of ordinary income or to characterize ordinary income as a capital gain. The arrangements typically involve an investment in a "purported" insurance company that is organized offshore, which then invests in hedge funds or investments in which those funds typically invest. Notice 2003-34 warns taxpayers and tax professionals that these arrangements often will not generate the US tax benefits that taxpayers claim.

Background

The typical arrangement the IRS is scrutinizing involves a stakeholder (*i.e.*, an investor) that is subject to US income tax and that invests (directly or indirectly) in the equity of an enterprise that is usually a foreign (*i.e.*, non-US) corporation. This foreign corporation ("FC") is organized as an insurance company and presumably complies with the applicable local laws regulating insurance companies.

FC issues "insurance or annuity contracts," or contracts to "reinsure" risks underwritten by insurance companies. However, some of the contracts do not cover insurance risks. Other contracts limit the risks assumed by FC through the use of retrospective rating arrangements, unrealistically low policy limits, finite risk transactions, or other similar methods.

Moreover, FC's actual insurance activities, if there are any, are relatively small compared to its investment activities.

FC invests its capital and the amounts it receives as consideration for its insurance contracts (*i.e.*, premium income) in, among other things, hedge funds or investments in which hedge funds typically invest. As a result, FC's portfolio generates investment returns that substantially exceed the needs of its insurance business.

FC generally does not currently distribute these earnings to the stakeholder.

The stakeholders or investors take the position that FC is an insurance company that is engaged in the active conduct of an insurance business and that is not a PFIC. Thus, when stakeholders dispose of their interests in the FC, it recognizes gain as a capital gain, rather than as ordinary income.

IRS Position

Insurance companies normally engage in a substantial amount of investment activity. It is simply part of what they do. Both life and non-life insurance companies routinely invest their capital and premium income. Their investment earnings are used to pay claims, support writing more business, or to fund distributions to the company's owners.

The presence of investment earnings does not, in and of itself, indicate that a business will not qualify as an insurance company.

The US Treasury Department and the IRS are not concerned about these companies. Instead, they are concerned that, in some cases, foreign companies and their stakeholders are inappropriately claiming that the foreign corporation in question is an insurance company for US income tax purposes to avoid tax that otherwise would be due. The IRS has decided to challenge the tax treatment these companies (and their investors) claim in the following ways.

Defining Insurance

For a foreign corporation or "FC" to qualify as an insurance company, the FC must issue insurance contracts.

Neither the Internal Revenue Code nor US income tax regulations issued under the Code define the terms "insurance" or "insurance contract." However, the US Supreme Court has said that for an arrangement to constitute insurance -- for US income tax purposes -- both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941).

The risk shifted and distributed must be an insurance risk. *See, e.g., Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190 (7th Cir. 1978), *cert. denied*, 439 U.S. 835 (1978). Risk shifting occurs if a person that is facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of that potential loss to the insurer. The effect of this transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment.

Risk distribution incorporates the "law of large numbers," which allows an insurer to reduce the possibility that a single claim will exceed the amount available to the insurer for the payment of a claim. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily involves the pooling of premiums so that a potential insured is not largely paying for its own risks. *See Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

In certain circumstances, the US Treasury Department and the IRS will take the position, where they deem it to be appropriate, that risks assumed under the contracts issued by FC might not be insurance risks. The government also might argue that the terms of the contracts significantly limit the risks assumed by the FC in question.

Among other things, the PFIC rules impose current US taxes (or similar treatment) on US persons that earn passive income through a foreign corporation.

What is an Insurance Company?

A corporation that is an insurance company for US income tax purposes is subject to tax under subchapter L of the Internal Revenue Code. For this purpose, an insurance company is a company whose primary and predominant business activity during the tax year is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies.

While a company's name, charter powers, and state regulation are indicators of the activities in which it may engage, whether a particular company qualifies as an insurance company for US tax purposes will depend on its actual activities during the tax year.

The IRS is likely to take the position that even if contracts qualify as insurance contracts, the character of all of the business actually done by a foreign corporation could indicate that the FC uses its capital and efforts primarily for investment purposes rather than in the insurance business. In those circumstances, the foreign corporation and its investors might fail to obtain the US tax benefits they claim.

Under §816 of the Code, a company will be treated as an insurance company only if "more than half of the business" of that company is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies. To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." *Industrial Life Insurance Co. v. United*

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States, 344 F. Supp. 870, 877 (D. S.C. 1972), *aff'd per curiam*, 481 F.2d 609 (4th Cir. 1973), *cert. denied*, 414 U.S. 1143 (1974).

To determine whether a foreign corporation ("FC") qualifies as an insurance company, the IRS has said that it will consider "all of the relevant facts, . . . including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income." (citations omitted)

As explained in Notice 2003-34, the IRS plans to scrutinize these arrangements in certain circumstances and to apply the PFIC rules whenever it determines that a foreign corporation is not an insurance company for US tax purposes.

In *Inter-American Life Insurance Co. v. Commissioner*, 56 T.C. 497, *aff'd per curiam*, 469 F.2d 697 (9th Cir. 1971), the Tax Court applied the standard set forth in §1.801-3(a) of the Income Tax Regulations (described above), and held that the taxpayer in question was not an insurance company because it was not using its capital and efforts primarily in earning income from the issuance of insurance. The court noted particularly the disproportion between investment income and earned premiums. It also noted the absence of an active sales staff soliciting or selling insurance policies.

In certain circumstances, the IRS is likely to take the position that even if contracts qualify as insurance contracts, the character of all of the business actually done by a foreign corporation could indicate that the FC uses its capital and efforts primarily for investment purposes rather than in the insurance business. In those circumstances, the FC and its stakeholders might fail to obtain the US tax benefits they claim.

Applying the PFIC Regime

Sections 1291-1298 of the Internal Revenue Code set out a special tax regime for investments in foreign corporations that are "passive foreign investment companies," commonly referred to as "PFICs." Among other things, the PFIC rules impose current US taxes (or similar treatment) on US persons that earn passive income through a foreign corporation.

Under the PFIC regime, a foreign corporation is a PFIC if:

1) 75 percent or more of the gross income of the company for the tax year is passive income; or
2) the average percentage of assets (determined under §1297(e) of the Code) held by the foreign corporation during the tax year, which produce passive income or which are held for the production of passive income, is at least 50 percent.

In this context, passive income generally means any income that is of a kind that would be foreign personal holding company income under subpart F of the Code (defined in §954(c)). This includes dividends, interest, royalties, rents, annuities, and gain from the sale or exchange of property giving rise to these types of income.

There is an exception to this rule -- "the insurance income exception" -- for income that is derived in the active conduct of an insurance business by a company that is predominantly engaged in the insurance business and that would be subject to tax under subchapter L of the Code if it were a US company.

If an FC would not be subject to tax under subchapter L if it were a US company (for the reasons discussed above), then the insurance income exception would not apply and the FC would be subject to the general income and assets tests for PFICs described above.

Additionally, even if the FC was subject to tax under subchapter L if it were a US company, the insurance income exception might not apply because the exception applies only to income derived in the *active* conduct of an insurance business.

As explained in Notice 2003-34, the IRS plans to scrutinize these arrangements in certain circumstances and to apply the PFIC rules whenever it determines that a foreign corporation is not an insurance company for US tax purposes.

Sources: IRS Notice 2003-34, 2003-23 I.R.B. 990 (June 9, 2003); and Deloitte & Touche's Tax News & Views. ❑

David Cooper is the editor of Practical US/International Tax Strategies. If you have any questions about this article, or about any items in Practical Strategies, please contact David at davidrcooper@earthlink.net.

Managing Offshore Hedge Funds
A View from the Beach

BY HANNAH TERHUNE
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Continuing our exploration of the US tax obligations of offshore hedge funds, this article considers the extent to which an offshore hedge fund can engage in diversified or entrepreneurial activities within the US, without "landing" there for tax purposes.

Many offshore hedge funds engage in a variety of activities within the US. To the extent that an offshore hedge fund becomes engaged in a US trade or business, all of its income and gains that are effectively connected to this business are subject to US tax.

At some point, an offshore hedge fund could cross the line between investing, trading, and banking activities. In these circumstances, the tax consequences for an offshore hedge fund are substantial.

This article explores the extent to which an offshore hedge fund can engage in diversified or entrepreneurial activities within the US, without "landing" for tax purposes, *i.e.*, subjecting a portion of its income to US tax on the basis that this income is effectively connected to a US trade or business.

We began our exploration of the US tax obligations of offshore hedge funds with an article in the May 15th issue of *Practical US/International Tax Strategies*. To obtain a copy of that issue, contact WorldTrade Executive, Inc. by telephone at 978-287-0301, or by email at *info@wtexec.com*.

Taxation of Offshore Hedge Funds

Offshore hedge funds generally engage in investment strategies to profit from capital appreciation and daily swings in the prices of stocks, other securities, or commodities. These profits are generally characterized as gain from the sale of capital assets (*i.e.*, capital gain).

Offshore hedge funds are not taxed on:

1) interest from US bank deposits or interest entitled to the portfolio interest exception under the US tax laws; and
2) capital gain, as long as the gain does not arise from the sale or exchange of a direct or indirect interest in real property located in the US.

To the extent that an offshore hedge fund becomes engaged in a US trade or business, all of its income and gain that are effectively connected to this business becomes subject to US tax -- without the benefit of the exceptions mentioned above.

Trade or Business

The term "trade or business" is not defined in the Internal Revenue Code or in US Income Tax Regulations issued by the Treasury Department and the Internal Revenue Service. Buying and selling stocks or other securities may constitute a trade or business, or this activity may fall within the scope of investing, which is not a trade or business.

> **At some point, an offshore hedge fund could cross the line between investing, trading, and banking activities. In these circumstances, the tax consequences for an offshore hedge fund are substantial.**

Over the years, the IRS has broadened the definition of investing activities, and narrowed the definition of a "trade or business," with a view to limiting business expense deductions. Investment expense deductions are subject to limitations.

Courts have drawn distinctions between investing, trading, and selling goods or services in the US to determine whether a foreign corporation is engaged in a US trade or business. Foreign investors are considered not to be engaged in a US trade or business even if they perform services to increase or protect the value of their investments. They are simply viewed as engaged in an activity for the production of income.

Moreover, foreign traders may be engaged in a US trade or business, but still qualify for exceptions that are applicable to certain trading activities.

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US Inbound Investment

With the intention of encouraging foreign investment in US financial markets, and realizing that trading in stocks and other securities may constitute a US trade or business, for US tax purposes, in certain circumstances, Congress provided two safe harbor exceptions within the scope of §864 of the Internal Revenue Code. Those exceptions apply to offshore hedge funds that are engaged in trading activities in US financial markets. They are the dealer safe harbor and the trading safe harbor.

Courts have drawn distinctions between investing, trading, and selling goods or services in the US to determine whether a foreign corporation is engaged in a US trade or business.

Dealer Safe Harbor

An offshore hedge fund -- whether or not a dealer in stocks and other securities abroad -- may trade in US stocks, other securities, and commodities (for its own account or for the accounts of customers) through a resident broker, commission agent, custodian, or other independent agent, provided that it does not maintain an office within the US through which, or by the direction of which, the transactions in stocks, other securities, or commodities are effected.

Trading Safe Harbor

The trading safe harbor applies to an offshore hedge fund that trades in stocks, other securities, and commodities for its own account, even if it:

1) maintains its principal office within the US for tax years after 1997; and

Over the years, the IRS has broadened the definition of investing activities and narrowed the definition of a "trade or business," with a view to limiting business expense deductions. Investment expense deductions are subject to limitations.

2) hires employees or exclusive agents in the US to direct its trading activities using their own discretion.

This exception covers trading in stocks, other securities, and options to buy or sell stocks or other securities, including margin transactions and short sales.

In 1997, the US Congress revised §864 of the Code to clarify that the exception from US tax for offshore hedge funds that actively trade US stocks, other securities, and commodities for their own account applies notwithstanding the fact that the funds maintain their principal office and perform administrative functions in the US.

This change in the law did not expand the trading exception to include activities beyond the scope of trading in stocks, other securities, and commodities.

Offshore Perspective on Trade or Business

No court has ever defined the term "trade or business" for purposes of applying §864 with respect to foreign corporations. The determination is made based on the facts and circumstances of each particular case.

However, once an offshore hedge fund has met an exception set forth in §864 with respect to its trading activities, all other activities must be vetted to determine whether those activities result in the creation of a US trade or business.

Notwithstanding the fact that an offshore hedge fund meets the trading safe harbor, the fund may still be considered carrying on a US trade or business for other reasons.

US Tax "Landings"

An offshore hedge fund should not assume that the trading safe harbor will always protect trading income or gains from US tax. How might an offshore hedge fund end up with effectively connected income?

Some hedge fund management companies offer US investors partnership interests in domestic partnerships, while offering foreign investors and US tax-exempt investors shares in the offshore fund. Offshore hedge funds are most often classified as corporations for US tax purposes.

A Hypothetical Scenario

Consider a scenario in which a private fund manager has captured the attention of the money manager of an offshore hedge fund. The private fund manager is the general partner of a hedge fund named "Hot Stuff, LP." Hot Stuff's general partner desires to quickly accommodate the interest of the foreign money manager to put funds under his management (*e.g.*, invest part of the offshore fund into Hot Stuff).

A "master / feeder arrangement," though it the works, does not yet exist. (The master / feeder fund structure was discussed in detail in the May 15, 2003 issue of *Practical US/International Tax Strategies*.) The offshore fund may invest in the domestic partnership as a type of modified master / feeder structure.

Hot Stuff's Private Placement Memoranda ("PPM") indicates that it is in its first year of operation. The PPM, read fairly against the backdrop of US case law, could tend to suggest that Hot Stuff's proposed trading strategy could give rise to either "trader" or "investor" tax status --*i.e.*, that it is an investment hedge fund as opposed to a trading hedge fund.

To date, the offshore hedge fund has traded in US financial markets free of US tax by relying on the trading safe harbor. In addition to investing in Hot Stuff, the offshore hedge fund will continue to trade directly in US financial markets.

The tax consequences to the offshore fund of an investment in Hot Stuff are risky. Notwithstanding the fact that an offshore hedge fund meets the trading safe harbor, the fund may still be considered carrying on a US trade or business for other reasons.

An FSA to Consider

In a 1998 field service advice, FSA 199909021 (December 1, 1998), the IRS advised that a US limited partnership's investment activity was not a trade or business and, therefore, a foreign corporation's distributive share of the partnership income was not taxable in the US as effectively connected income.

In that FSA, a foreign corporation held an interest in a domestic limited partnership, which primarily invested in stocks. The limited partnership's offering documents indicated that its objective was to invest its committed capital in a diversified portfolio of leveraged equity investments and that it expected to hold those investments for two to six years. The investments produced interest and dividend income, and capital gain.

The FSA clearly left the door open to concluding that an offshore investor in an actively traded domestic hedge fund that is structured as a partnership (or a limited liability company electing to be taxed as a partnership) would "land" in the US for tax purposes by operation of law pursuant to §875 of the Code.

In short, an offshore hedge fund that is a partner in a partnership or a beneficiary of a trust that is engaged in a US trade or business is treated and taxed as being so engaged. However, an ownership interest in a US investment partnership or an investment trust should not, by itself, cause an offshore investment fund to be considered to be engaged in a US trade or business.

Avoiding US Trade or Business Status

How might the offshore fund manager have avoided "landing" in the US for US tax purposes? Instead of investing directly in Hot Stuff through the purchase of a limited partnership interest, the offshore hedge fund could have loaned funds to Hot Stuff.

Domestic hedge funds, such as Hot Stuff in our scenario, typically trade on "margin" and borrow funds to leverage investment capacity. With respect to this loan, the interest charge and offsets could have been structured as a type of "tracking" investment with the goal of establishing a rate of return with an economic yield (net of performance and management fees) equivalent to the yield expected by a typical limited partner in Hot Stuff.

In short, an offshore hedge fund that is a partner in a partnership or a beneficiary of a trust that is engaged in a US trade or business is treated and taxed as being so engaged. However, an ownership interest in a US investment partnership or an investment trust should not, by itself, cause an offshore investment fund to be considered to be engaged in a US trade or business.

The question arises whether this loan would create a US banking business for the offshore hedge fund? Statistics indicate that more than half of the total receipts of effectively connected income reported by offshore entities arise from the provision of banking, insurance, and other financial services.

According to US income tax regulations, a banking business includes any one of the following activities: (a) receiving deposits of funds from the public; (b) making personal, mortgage, industrial, or other loans to the public; (c) purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (d) issuing letters of credit to the public and negotiating drafts drawn those letters; (e) providing trust services for the public; and (f) financing foreign exchange transactions for the public.

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Generally, limited venture capital activities should not cause an offshore hedge fund to be engaged in a US trade or business. According to the income tax regulations, those activities may include searching for companies in need of financing, negotiating an investment structure with the companies' existing management, occasionally making bridge loans to the companies, participating in the management of the companies, and holding the investments to profit from capital appreciation.

An "Ideal" Structure

In the debenture investment proposed above, it would be ideal to structure the interest yield as one qualifying for the portfolio interest exception in situations in which a reduced treaty rate is not available to lower the default statutory withholding taxes rates applicable to outbound interest payments.

In the debenture investment proposed in this article, it would be ideal to structure the interest yield as one qualifying for the portfolio interest exception in situations in which a reduced treaty rate is not available to lower the default statutory withholding taxes rates applicable to outbound interest payments.

Foreign partners are subject to US withholding tax on dividend income and non-portfolio interest income. This is especially critical if the offshore hedge fund is not a corporation, but rather a partnership.

An offshore hedge fund, structured as a partnership, which only trades for its own account and does not otherwise engage in a US trade or business, is not required to file Schedule K-1s on behalf of its foreign partners. However, a foreign partnership that generates effectively connected income must file a complete US partnership return, with Schedule K-1s for all partners, including the foreign partners.

Compliance with the withholding regulations applicable to a tiered, inbound investment is difficult and time-consuming to manage.

The IRS will not issue a private letter ruling to a foreign corporation for the purpose of determining whether it is engaged in a US trade or business. Despite the wealth of US inbound investment, the IRS has issued very little guidance in this area, other than to state that each determination will be based on all of the facts and circumstances involved in a particular case.

Given the magnitude of the consequences, it is important to vet proposed US inbound investments to be certain of their potential US tax consequences. ❑

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against the euro since the inception of that currency and many commentators believe the US economy is losing its dominance.

A Tax Disadvantage

Combined US and state corporate tax rates are substantially higher than the corporate rates imposed by most other industrial countries. EU countries average a corporate tax rate of 31.8 percent, and OECD (Organization for Economic Cooperation and Development) countries average 30.5 percent, as compared to a top corporate tax rate of 35 percent in the US. The OECD now has 30 permanent member countries and includes all of the world's major economies.

Congress and the current Bush Administration have finally recognized that US businesses must be positioned to compete fairly in the global marketplace. Kenneth W. Dam, Deputy Secretary of the Treasury, is quoted as saying:

> The sad truth is that our international tax rules serve no national interest . . . Yet changes to the international provisions of the US corporate tax code in recent decades have ignored this trend, and have oftentimes more impaired than improved American companies' ability to compete abroad.

No Export Incentives for US Companies

Revising the US tax code has proven to be an uncertain and perilous task. In addition to the political uncertainties of pending legislation, the World Trade Organization ("WTO") has taken a dim view of US export incentives.

The purpose of the WTO, with 146 members as of April 2003, including the US, is to regulate and facilitate free trade among its member states. WTO decisions are often controversial, and many commentators feel it is becoming more of a judicial body than a regulatory one.

The WTO has ruled that the US foreign sales corporation ("FSC") regime, enacted in 1983 as a kind of tax subsidy for exports, is an "illegal trade subsidy." The US Congress enacted the Extraterritorial Income Exclusion Act ("ETI Act") to allow a limited tax exemption on export income earned by US companies. The WTO ruled that the ETI regime is also an illegal subsidy and has now authorized the EU to impose substantial trade sanctions against the US unless the US eliminates this illegal subsidy.

The importance of the FSC-ETI regime is illustrated by the fact that large exporters, like Boeing and Motorola, report that FSC-ETI tax savings represented more than 10 percent of their total net income from 1996 to 2000.

In April, a bipartisan bill (H.R. 1769) was introduced to replace the FSC-ETI regime with a tax rate reduction for income related to the export of certain "qualifying property." A tax rate reduction might pass WTO scrutiny, but this is far from guaranteed.

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The WTO purports to prohibit unfair tax incentives, but it does not regulate "consumption taxes," commonly known as value-added taxes or "VAT." Of the 30 OECD members, only the US does not impose VAT. The VAT system itself provides an export subsidy simply because exported products are not subject to VAT in the country in which the goods are manufactured. *See* "Globalization: US Companies at a Disadvantage," by Stephen A. Malley (September 2002).

Dividend Taxation

The Bush Administration and the US Congress have also addressed the taxation of dividend income and the strict limits imposed on use of foreign tax credits. The US, the Netherlands, and Switzerland are the only OECD member countries that currently do not allow a total or partial tax credit for corporate dividends. US companies already receive the dividends received deduction for dividends received from their domestic subsidiaries, but dividends received from foreign subsidiaries are generally fully taxed (except for US-related income).

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The Senate Finance Committee considered a narrow rule that would allow an 85-percent dividends received deduction for dividends received from controlled foreign corporations ("CFCs"), but only with respect to actual and "deemed dividends" resulting from an investment in US property under §956 of the Internal Revenue Code. Moreover, this proposal was of limited duration -- the tax break would end on June 30, 2004.

Perhaps the most restrictive US international tax regime that requires improvement is subpart F. The arcane and arguably anachronistic subpart F tax rules generally require a US parent company to take its foreign subsidiaries' profits into current US income.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 signed into law last month provides for a 15 percent tax rate on dividends paid to non-corporate taxpayers from a foreign subsidiary, but with certain limitations. This provision, limited to non-corporate owners of foreign entities, will be of limited benefit to US businesses.

Treaty Developments

It should be noted that a new and positive development is exemplified by the new US income tax treaties with the UK, Mexico, and Australia. The new US treaties with these countries generally eliminate withholding tax on dividends paid by an 80-percent owned subsidiary in one treaty country to its parent in another. *See, e.g.*, "Deferring US Taxes on Foreign Business Income," *Offshore Investment Journal* (May / June 2000), by Stephen A. Malley.

Reduced withholding tax rates also apply to 10-percent owned subsidiaries.

Several other treaties, which may also eliminate tax on dividends, are currently under negotiation, including those with Japan, the Netherlands, France, Canada and Korea. While these treaties might not provide direct US tax relief to US parent companies, it should alleviate the burden and limitations relating to the use of foreign tax credits.

Limitations on the Foreign Tax Credit

US income tax treaties generally allow a credit against US tax for taxes paid to a foreign country, but the US tax code imposes significant restrictions on the use of the foreign credit. Among other things, the code generally limits the application of the credit by using a formula -- the US tax on worldwide income multiplied by the ratio of foreign-source income to worldwide income.

Further, US companies are subject to the alternative minimum tax ("AMT") on foreign tax credits. Credits are limited to 90 percent of the AMT. Unused foreign tax credits can be carried back for only two years and carried forward for only five years.

There are several proposals before Congress to liberalize the use of the foreign tax credit, including S. 2676, the Foreign Tax Credit Improvement Act of 2002, and H.R. 5095. All of the bills would liberalize the use of the foreign tax credit and allow a 10-year carryforward. They would also allow full crediting against the AMT.

The Taxpayer Relief Act of 1997, which is now fully in effect, also gives some relief by eliminating the separate foreign tax credit "baskets" for dividends from foreign subsidiaries. The application of the new rules is complicated and highly technical. They are also likely to be superceded by new legislation, if it is enacted.

Subpart F

Perhaps the most restrictive US international tax regime that requires improvement are the subpart F rules under §956 of the Code. Regardless of the business purposes involved, the arcane and arguably anachronistic subpart F tax rules generally require a US parent company to take its foreign subsidiaries' profits into current US income. Exceptions can apply to a subsidiary actually manufacturing or producing in its country of incorporation, in specific and limited circumstances.

On the other hand, at least half of the OECD member countries do not tax the parent companies within their jurisdiction on the active income earned by foreign subsidiaries, although many countries do limit the advantages of using "tax havens" or low-tax jurisdictions.

For example, Germany defines a low-tax jurisdiction as one with a tax rate of less than 30 percent. The UK generally will not impose tax on overseas profits if the primary purpose for the offshore subsidiary is not the avoidance of UK taxes. France taxes corporations on a "territorial basis," and profits from active overseas subsidiaries are generally tax-exempt, regardless of the tax rates those subsidiaries pay.

The so-called "contract manufacturing exception" to the subpart F rules purports to attribute the manufacturing in a country other than that of incorporation to the subsidiary and thereby allow the US parent to defer US tax on profits until repatriated to the US. However, the IRS has shown reluctance to apply the exception.

There are any number of compelling reasons for a US company to establish foreign subsidiaries. They include, for example, compliance with local labor laws, political purposes, liability protection, favorable treaties, and, most importantly, to facilitate and expedite manufacturing and sales.

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However, the IRS has indicated its reluctance to apply the contract manufacturing exception, although an IRS field service memorandum and several recent cases indicate that it can work if specific criteria are met.

There are several bills pending in Congress, which relate to the subpart F rules. For example, H.R. 5103 would increase the subpart F *de minimus*

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exception to $5 million from the current $1 million. H.R. 5095 would effectively repeal most of the subpart F rules.

Expatriation and Inversion

Another issue attracting congressional attention is the now much publicized "migration" of companies to low-tax jurisdictions. Several public companies have reincorporated overseas

Another issue attracting congressional attention is the now much publicized "migration" of companies to low-tax jurisdictions. Corporate migration is a direct result of the restrictive US tax code and, in particular, the subpart F provisions discussed in this article.

or merged with a foreign subsidiary. Many have become Bermuda corporations. Ingersoll-Rand, Tyco, Cooper Industries, and Stanley Works are just a few of the larger US companies to migrate overseas. These companies may retain their US operations and may have only a mail drop or a "representative office" with no employees in the foreign jurisdiction.

Corporate migration is a direct result of the restrictive US tax code and, in particular, the subpart F provisions discussed above. S. 2119 and H.R. 5095 would treat "inverted corporations" as domestic (US) corporations if, for example, more than 80 percent of the stock of the "new" foreign corporation or entity is held by former shareholders of the domestic corporation. Many commentators believe the passage of any legislation of this kind will be difficult, and that the better approach is to modify the US tax rules affecting international businesses. ❑

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