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International Tax Strategies - Reduce Your Tax Rate!

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Microsoft's paying a 7 percent tax rate! How, you ask? By utilizing some basic international tax strategies which might apply to you! The fact is, few large U.S. companies pay the standard U.S. corporate rate of 35 percent.

According to a recent study reported by Thomson Reuters, nearly $1.2 trillion of accumulated U.S. corporate profits are now held in overseas subsidiaries. The U.S. government taxes U.S. businesses on income earned worldwide, but allows them to defer taxes until the money is brought back to the U.S., so many corporations keep profits abroad, particularly as they increase investment overseas.

Some Congressional leaders have even begun calling for a "repatriation holiday" that would allow corporations to bring back money held offshore at a lower rate (5.25 percent has been kicked around) similar to a one-off deal in 2005 through which corporations brought back $312 billion.

A few strategic ways to effectively reduce your tax rate are through establishing foreign corporations, a captive insurance company and/or establishing an IC-DISC.

Foreign Corporations: Deferral and Control

The most important limitation on the worldwide taxation of United States persons results from the treatment of foreign corporations. Foreign corporations are generally not subject to U.S. tax on their foreign source income. This remains largely so even when the foreign entity is owned entirely by U.S. shareholders, a reflection no doubt of the basic principle in U.S. corporate and tax law of treating corporations as entities separate from their owners. U.S. persons can therefore remove many overseas business undertakings from the reach of current U.S. taxation by conducting them through their own controlled foreign corporations. This regime is known as "deferral" because, when it applies, the earnings of foreign corporations owned by Americans are not subject to U.S. income tax until actually returned to U.S. shareholders as dividends or other gains constituting currently taxable income; therefore, U.S. tax is accordingly deferred on undistributed foreign earnings that remain invested in foreign business operations. The deferral of U.S. taxation, given the time value of money, can be extremely valuable, with the obvious constraint that deferral is worthwhile only when the foreign rate of taxation is significantly lower than the U.S. rate, and the less obvious constraint that there is also little benefit from deferral unless the U.S. tax on repatriated income can be minimized or avoided. If no foreign taxes are imposed, protracted or indefinite deferral can be virtually as valuable as total exemption from U.S. tax.

Unlimited deferral would leave open similarly unlimited opportunities for tax avoidance. Assets producing passive income, and even active business operations, could be tucked into corporations organized in low tax jurisdictions beyond the reach (and at the expense) of the treasuries of any of the industrial and commercial countries.

A number of U.S. tax provisions limits the scope of deferral. Generally, deferral remains possible for active business operations undertaken through foreign corporations. It is not available, however, for a variety of "tax haven" operations, conducted through so-called "controlled foreign corporations;" that is, corporations under the actual control or ownership of a small number of U.S. shareholders. The passive investment income and tax haven earnings of these controlled foreign corporations are immediately taxable to their U.S. shareholders, as well as certain investments of U.S. persons in non-controlled foreign corporations. In the past 45 years there have been substantial inroads on the scope of deferral, and a concomitant enlargement of current taxation, such that the surviving domain of unalloyed deferral is populated largely by shareholdings in foreign corporations engaged in active business operations overseas.

Summary:

The establishment of foreign corporations can be complex and costly, but as we see in the highly reported case of Microsoft, the benefits can be tremendous, perhaps even achieving a 7 percent tax rate for your business!

Captive Insurance Company – 200-year-old strategy

A "captive" is an insurance company that insures the risks of its owner, affiliated businesses, or a group of companies. It issues policies, collects premiums, and pays claims. It is an alternative to traditional commercial insurance and reinsurance options. Whereas a commercial insurer is owned by a broad base of stockholders or policyholders, a captive is owned by a finite group of owners or owner. Many of the Fortune 500 companies utilize this strategy not only for insurance reasons but for tax reasons as well.

An insurance company, including a captive, may elect pursuant to 28 U.S.C. sec. 831(b) to be taxed on its investment income only, so long as the company receives less than $1.2 million in premiums each year. The 831(b) election is filed along with the company's first tax return, and cannot be revoked without the consent of the Secretary of the Treasury.

This election is an incentive provided by Congress to encourage the formation of new insurance companies. What 831(b) effectively allows, is for a small insurance company to receive up to $1.2 million per year in premiums, without paying *any* income taxes on those premiums!

The 831(b) election does not affect – at all – the deductibility of the premiums paid by the operating business to the captive. So long as those premiums are otherwise deductible, they may be deducted by the operating business just like any premium payments to a captive. This has the effect of creating a deduction of up to $1.2 million in the operating business, with the premium moneys transferred to the captive, and with the captive not paying any income taxes on the receipt of those premiums.

The first captives date back to the 1800s when a New England textile manufacturer created a group captive (in the form of a mutual company) in response to high fire insurance rates of that period. Sound familiar?

Summary:

Essentially, an operating company can insure risks up to $1.2 million in their own captive insurance company, deduct the premiums against operating income, and pay NO taxes as the insurance company due to the provisions granted under 831(b)! Be sure to deal directly with your tax advisor, actuary and legal counsel in order to avoid all the middle men running around town selling this concept as an annuity to their business. While expensive to establish, by going direct to the required advisors, you can slash your costs of maintaining these entities significantly. These entities can be established in over 60 foreign domiciles or almost any U.S. state now.

IC-DISC – Running out of Time?

Interestingly, you don't need to necessarily establish foreign corporations to achieve some significant tax breaks. The establishment of an IC-DISC might be considered for those qualifying companies.

Essentially, an IC-DISC is a domestic corporation principally involved in selling U.S. goods and some qualifying services overseas. Congress enacted the regime to try to stimulate exports. You see, a DISC is a tax-exempt entity.

As a threshold, to qualify for an IC-DISC, the U.S. exporter must have U.S. export property, produced or manufactured in the U.S., with 50% U.S. content, which is sold primarily to offshore customers. Setting-up an IC-DISC is designed to be very simple. It must be a C-Corporation organized under the laws of any state or the District of Columbia, with only one class of stock that has a par value of at least $2,500. Shareholders file a Form 4876-A, "Election to Be Treated as an Interest-Charge DISC," with the IRS within 90 days after the beginning of the tax year. IC-DISCs do not need the typical corporate "substance" requirements – most IC-DISCs are "paper" entities and are not required to perform substantial economic functions nor have employees and office space. The IC-DISC must only maintain its own books and records separate from the export company. Despite lacking the typical substance one would expect from a corporate entity, the IC-DISC is treated as a viable entity for legal and tax purposes.

When established correctly, the IC-DISC will be able to dividend its deferred income back to its shareholders at 15%, thus converting 35% ordinary income to 15% dividend income.

The IC-DISC tax benefit comes by way of a commission payment from the exporter to the IC-DISC. The commission payment is an actual payment from the U.S. exporter to the IC-DISC, and is determined as either 4% of the U.S. exporter's qualified export receipts or 50% of the exporter's taxable income (whichever is greater). The commission payment to the IC-DISC is fully deductible for the U.S. exporter and is only minimally taxable on either a deferral basis or at favorable dividend rates.

Summary:

Generally, shareholders may defer up to $10,000,000 of annual commission income in the IC-DISC. If the IC-DISC defers this income, there is a shareholder level tax on the deferred tax. If the shareholders decide not to defer, currently, the IC-DISC commission income is taxable to the shareholders as a dividend. Unfortunately, the dividend tax rate of 15% is set to expire at the conclusion of 2012 unless Congress and the President agree to an extension of this tax benefit, so this may be the final year of seeing significant benefits from an IC-DISC strategy.

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