

Valuation Supports International Tax Strategies

Multinational corporations utilize a number of strategies when addressing international tax compliance and planning opportunities. A fair market valuation is often an integral part of the tax analysis. In this Alert, we highlight some of the major tax/valuation strategies in the international arena.

CHECK THE BOX

Check the box (CTB) is a special election permitted under U.S. tax law which generally is used to treat a legal entity as “pass-through” as opposed to “stand-alone” for tax purposes. Stand-alone entities, such as Subchapter C corporations, compute their own taxable income and pay tax on this income. Pass-through entities, such as Subchapter S corporations, LLPs and LLCs, compute their own income and then assign it to their shareholders or partners usually on a proportionate basis. Multinational corporations use CTB elections to accelerate foreign income and related foreign tax credit. CTB elections are also used to combine income and losses in foreign operations to reduce the effective foreign tax rate on the repatriation of foreign earnings.

The CTB election results in a deemed liquidation of the electing legal entity and the formation of a new legal entity. In a liquidation, the stock of the legal entity is retired and the shareholders take over its assets and liabilities. The company is deemed to have sold its assets and liabilities for fair market value to the shareholders in return for their stock in the company. The shareholders are deemed to have sold their stock in the company in return for the fair market value of the assets and liabilities. A valuation is needed in order to determine the tax consequences of the liquidation and to establish the tax bases and capital accounts of the new legal entity.

SECTION 1.861-9 FAIR MARKET VALUE ELECTION

For purposes of computing a U.S. taxpayer’s allowable foreign tax credit, Section 864 (e) requires that interest expense deducted on the U.S. tax return be allocated and apportioned to U.S. and foreign source income. This allocation and apportionment is based on the relative values of U.S. and foreign assets (as those terms are defined) to total assets. Maximizing the relative value of the U.S. assets to total value increases the allowable foreign tax credit since it results in an increased amount of interest expense being apportioned to U.S. income and thus away from foreign income. The U.S. taxpayer can elect to use fair market valuation (rather than tax book value) to determine the relative value of the U.S. and

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foreign assets under the pertinent provisions of Section 1.861-9 of the Tax Regulations. This election is particularly advantageous in situations involving U.S. based intangible property with high fair market value but low or no tax book value.

BUSINESS ENTERPRISE VALUATIONS (BEVs)

The fair market value of foreign subsidiaries as separate business enterprises is crucial to international tax planning for the proper legal entity structure. Multinational companies frequently realign their worldwide legal entity structures to achieve host country tax savings or to facilitate cash repatriation to the United States. When one foreign subsidiary is acquired by another foreign subsidiary, Section 304 of the Code deems a dividend to the U.S. common parent of the acquiring subsidiary. This dividend treatment is based on the fair market value of the acquired subsidiary as well as relevant earnings and profits calculations.

In situations where the foreign subsidiary's business has deteriorated, Section 165 (g) (3) allows an ordinary (as opposed to capital) deduction for the U.S. parent's tax basis investment in the subsidiary. This deduction is contingent on proving a worthless stock loss as defined under U.S. tax law. The first step in the determination of worthlessness is the substantiation that the fair market value of the subsidiary's liabilities exceeds the fair market value of its assets. Valuation analyses thus form the basis for determination of the tax effects of legal entity restructure planning as well as the possibility of a worthless stock deduction.

OUTBOUND TRANSFERS OF INTANGIBLE PROPERTY (IP)

The definition of IP for U.S. tax purposes includes items other than just patents, copyrights, and trademarks that are registered with the government. The tax definition of IP includes such items as customer lists, manufacturing know-how and workforce in place. Multinational companies transfer these items offshore for a variety of reasons. For example, the multinational could be establishing a regional center of competence to handle functional areas such as customer support, manufacturing and R & D. The multinational may be distributing a domestic subsidiary with IP to its foreign shareholders or may be transferring background IP to an offshore R & D center to establish a worldwide R & D cost-sharing arrangement. In any event, the tax consequences of transferring IP offshore are determined by reference to the IP's fair market valuation.

TRANSFER PRICING

Multinational companies face several compliance and planning issues in addressing the worldwide arms-length standards applicable to intercompany transfer pricing. Valuation analyses are integral to a worldwide transfer pricing strategy, particularly to proper valuation of IP for purposes of setting a supportable royalty, tech fee, or other charges for access to the IP. For more information, contact your Valuation Research representative or Robert Cronin at (630) 990-2626. **VR**