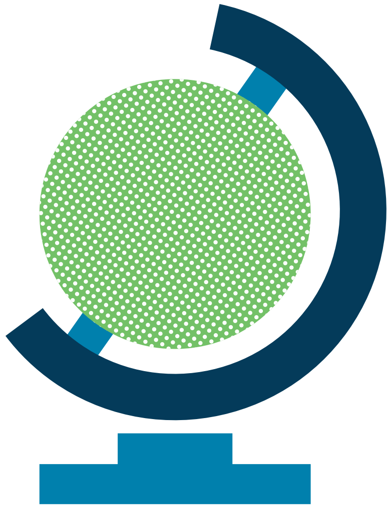

INTERNATIONAL TIDBIT:

Should a Foreign Parent Company Consider Filing a U.S. Tax Return?

An issue that may arise in IRS audits involving a U.S. subsidiary ("USCO") of a foreign parent company ("FORCO") is whether FORCO is doing business in the U.S. and should be filing a U.S. tax return to report its income effectively connected with a U.S. trade or business, to report it is exempt from tax under a double taxation treaty, or to protect its right to deductions and credits if it is ever subject to U.S. federal income tax. Most commonly, this issue arises when FORCO is selling products to USCO and USCO acts as a distributor or agent in the U.S. It can also arise when FORCO performs services and subcontracts work to USCO.

IMPORTANCE OF FORM 5472

The starting point for the IRS on the trail of FORCO is Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) filed with USCO's Form 1120 (U.S. Corporation Income Tax Return). Forms 5472 are used to report transactions between USCO and certain related foreign entities, including purchases of goods and performance of services.

FOREIGN PARENT *DOING BUSINESS* IN THE U.S.

One approach the IRS may take is to argue that FORCO really runs USCO's business and therefore FORCO has a "permanent establishment" or "PE" in the U.S. (under a treaty definition) or is conducting a trade or business in the U.S. (within the meaning of IRC section 872). In the case of a PE, FORCO would be taxable on business profits attributable to a PE while, in the absence of a treaty, FORCO would be taxable on its income "effectively connected" with a U.S. trade or business. For sales of products, this could involve taxing FORCO on its gross income from sales to USCO in addition to the tax USCO is already paying on its own income. If FORCO is in a services business, its revenues from services such as those it may have subcontracted to USCO could become subject to U.S. tax.

ALTER EGO OR ECONOMIC INDEPENDENCE

The IRS may reach these conclusions by arguing, for example, that USCO is not economically independent of its parent FORCO or is its alter ego. Such a lack of independence might be shown if USCO fails to earn an arm's length margin on the goods it sells or the services it performs. Another argument is that USCO does not act as a separate enterprise because all of its transactions must be approved by FORCO or because FORCO's employees are handling all the solicitation and negotiation of the contracts entered into by USCO with its customers.

TRACKING TRAVELERS

Documentation requested by the IRS in bolstering a "lack of economic independence" argument can include travel records of FORCO's employees who come to the U.S., and details about what they do here, where they meet, and with whom. For example, if officers of FORCO are regularly traveling to USCO's Houston office and are involved in generating business with U.S. customers, it appears that FORCO has a U.S. trade of business even if the resulting contracts are ultimately signed by USCO.

RISKS OF NOT FILING

The stakes may be very high for FORCO if it does not file Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) and the IRS ultimately concludes that FORCO is engaged in business in the U.S. IRC section 882(c)(2) permits FORCO to receive the benefit of deductions and credits only by filing a tax return. By the time an IRS audit of USCO occurs and the exposure to U.S. tax of FORCO is identified, it may be too late to file a return that is considered timely for purposes of complying with IRC section 882(c)(2). The result is that FORCO would be taxed on its gross income. To make matters worse, the U.S. tax paid by FORCO might not be creditable in its home country, especially if there is no treaty with the U.S.

Considering the potential costs, FORCO may decide to protect its position and preserve the ability to take deductions and credits by filing Form 1120-F to reflect no income effectively connected with a U.S. trade or business. The return must be filed on a timely basis and in a true and accurate manner in order for FORCO to take deductions and credits when determining income effectively connected with a U.S. trade or business, if such a calculation ever becomes necessary.

DUE DATES

For foreign corporations without an "office or place of business" in the U.S., IRC section 6072(c) provides that the 2011 return for a calendar-year company is due June 15, 2012, but an extension may be filed for an additional six months. What comprises such an office or place of business is not defined.

Treasury Regulations under IRC section 882 provide a cut-off date beyond which a return cannot be filed by a foreign corporation seeking to take deductions and credits. Assuming that FORCO is a calendar-year company and had an "office" in the U.S., its Form 1120-F for 2011 would be due no later than 18 months after the original due date of March 15, 2012. In other words, the 2011 return would be due by September 15, 2013. This also means that FORCO could timely file for only one prior year, 2010, for which it would have until September 15, 2012 to submit the 2010 return. Other rules may apply, especially if FORCO filed in any earlier years.

TREATY-BASED RETURN

FORCO should also consider filing a protective return if it determines, initially, that it has no U.S. tax to pay because a double taxation treaty with its country of residence provides an exemption. In that case, it would need to include Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) with Form 1120-F. Filing a so-called treaty-based return would also preserve the ability to claim deductions and credits if FORCO's position proves wrong in a subsequent IRS audit.