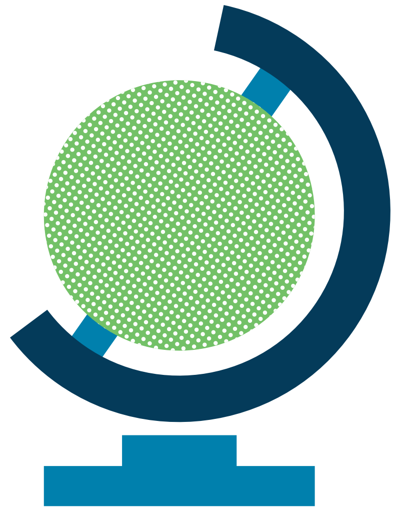

INTERNATIONAL TIDBIT:

What’s in a Name? Enquiring Minds Want to Know

Shakespeare may not have had taxpayers in mind when he gave Juliet the line, "What's in a name?" But a name, in the sense of what label international parties affix to their cross-border agreements may cause unintended and expensive tax consequences, depending on which tax authorities are involved.

The U.S. has long taken the approach that the substance of an arrangement, rather than what the parties name it, will govern its tax treatment. Other countries may place greater emphasis on how an agreement is titled, which can result in pitfalls as well as opportunities for tax planning, such as those examined here.

OUTBOUND EXAMPLES

For U.S. companies operating outside the U.S., the name used on an agreement may determine tax implications in a foreign country, such as in the following examples:

(1) Amount of Tax Withheld from Payments. Providing both services and equipment to a foreign subsidiary under a “Services Agreement” might trigger a high withholding tax and possibly even a transfer of technology. Bifurcating the contract into (a) a lease of equipment, and (b) an agreement to provide services, may reduce the total amount of withholding tax and ensure that the tax is fully creditable against U.S. tax on foreign source income. This is because a lower rate of withholding or possibly an exemption from tax under a double taxation treaty may be available for rental payments pursuant to a Lease.

(2) Limits on Deducting Expenses. In some countries, head office expenses or management fees charged by a U.S. company to recover a portion of the costs related to services benefiting a foreign subsidiary might not be deductible in the subsidiary’s country or might be subject to limits based on income or other deductions. Recovering that amount as part of other charges, such as an increased rent for the use of equipment or a fee for non-head office services, may be preferable if these other charges are not subject to limitations on deductibility. In this way, there is also a greater likelihood that both the U.S. company and its foreign subsidiary can fulfill their obligations under transfer pricing rules without accumulating large balances that can never be paid to the U.S. but might still be recognized as income here.

(3) Registration Requirements Linked to Payments. Some countries require the registration of agreements with the Central Bank if they involve any aspect of financing and require payment in a foreign currency such as U.S. dollars. If a Lease with Option to Purchase calls for periodic payments and includes an interest component, it might be characterized as a loan or finance lease under foreign law, leading to a requirement to register it. By removing the purchase option and building an interest component into the overall purchase price, the registration requirement and any attendant delay in payments might be avoided.

(4) Transactions Involving Computer Software. U.S. Treasury Regulations prescribe specific treatments for cross-border transactions involving computer software programs.   Examining characteristics such as what rights are granted to a foreign transferee and for how long, a transaction may be treated for U.S. tax purposes as a sale or license of a copyright, or a sale or lease of a copyrighted article. A License Agreement permitting a foreign person to use a computer program, but not to make copies of it and sell it, would be a "sale" for U.S. tax purposes. But the label "License Agreement" may be controlling under foreign law, leading to the payment being subject to withholding tax in the country where the transferee is located. Modifying the agreement and calling it a "Sale" might avoid the purchase price being treated as a royalty subject to withholding tax in the foreign country.

INBOUND EXAMPLES

There are also situations in which foreign investors have entered into transactions where the label can have unexpected consequences under U.S. tax rules.

(1) Redemption Treated as Dividend. If a U.S. company wants to reduce its capital by buying back or redeeming stock from a foreign shareholder, the transaction labeled a "Stock Repurchase" may lead to the payment being treated as a dividend, especially if proportionate among all the shareholders and the company has undistributed earnings. Characterization as a dividend creates the responsibility to withhold U.S. tax from the payment to the foreign shareholder (unless exempt under treaty), and to report the payment of U.S. source income on Form 1042.

(2) Loan as Capital Contribution. It is not uncommon for foreign parent companies to use loans as a way to reduce taxable income in the U.S. through deductions of interest payments. However, if that U.S. subsidiary is undercapitalized, the IRS has the authority to recharacterize a Loan between related parties as an additional capital contribution. This would eliminate the deduction for interest expense even though the foreign parent company is still required to recognize interest income in the country where it is resident.

(3) Contractual Joint Venture as Partnership. Two foreign companies may enter into a contract labeled a Joint Venture to pursue a business opportunity in the U.S. In the process of engaging in a U.S. trade or business, they may create a partnership for U.S. tax purposes, meaning that a U.S. partnership tax return must be filed even though no legal steps have been taken to create a partnership under the law of the country where they are organized. Each of the "partners" must file a U.S. tax return to report its share of profits from the partnership and the partnership will have responsibilities to withhold U.S. tax from income effectively connected with a U.S. trade or business.

(4) Sale of Software Treated as a Lease. A License or Sale of a software program may permit a U.S. person to access a program on-line and use it for a limited period of time, such as a month, or for as long as payments continue to be made. Because there is no grant of a right to copy and distribute the program, the transaction is not a license of a copyright for U.S. tax purposes. Instead, and because the limited rights to use the program are for a specific time period, the transaction would be treated as a lease of a

copyrighted article and subject to withholding tax of 30% (or possibly less, under a treaty) rather than a sale, which would not be subject to withholding tax.

As these examples show, what's in a name can be significant, and costly, if the tax implications are not anticipated by the parties before an agreement is inked.