



*We are pleased to send you this second issue of Meaden & Moore's International Tax news and hope you find the content useful. We would appreciate your feedback on our efforts to raise awareness of critical International tax issues.*

*Please send any suggestions or topics you would like us to address to William Harwood at [wharwood@meadenmoore.com](mailto:wharwood@meadenmoore.com) or call us at (216) 928-5411.*

## Overview of Tax Issues Surrounding Controlled Foreign Corporations

Some of the very technical and complex provisions of U.S. taxation on international operations have moved from the exclusive province of large multinational corporations into the domain of mid-sized companies. The obvious cause of this wider application is in the increase globalization of markets.

But globalization has been a fact of the market for goods and services for over 30 years, beginning with high volume automobile imports, then electronic consumer goods, on to financial services, until today where the global reach touches virtually every purchase made at every level of the supply chain. Not only does the breadth and scale of globalization expand geometrically, but the means of production changes rapidly to capture every cost advantage in highly price competitive or elastic markets.

Today, U.S. manufacturers and service providers are looking to outsource to foreign companies. Outsourcing often (not always) makes sense when Company A can pay Company B to perform some function at a price that is less than it costs Company A. Company B's costs to perform that function are so much lower than Company A's that Company B can earn a profit even after increased quality and logistics costs. Virtually every U.S. company with revenues in excess of \$5 million either considers, or is to some degree, foreign outsourcing. It is no

wonder that the percentage of U.S. companies that create foreign subsidiaries and engage in foreign joint ventures has risen dramatically, and so has the number of U.S. companies that must deal with sometimes complex U.S. tax rules directly affecting investments in Controlled Foreign Corporations, or CFCs. The CFC rules were established in the Kennedy administration to put an end to the growing practice of "parking" business profits in tax havens, beyond the reach of the IRS. CFC rules became increasingly complex because of conflict between economic policy that encourages U.S. companies to increase sales in foreign countries, and tax policy that aims to prevent abusive tax avoidance.

Growth requires investment. In order to encourage U.S. companies to expand globally, the CFC rules generally allow companies to defer U.S. tax on the profits earned in a foreign subsidiary so long as the foreign earnings are reinvested in the expansion of the company's foreign operations. When the earnings come back to the U.S. in the form of dividends or loans to the U.S. parent, then the foreign earnings are subject to current taxation in the U.S.

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In order to prevent abuse of the U.S. tax deferral on CFC income, a number of qualifications must be continuously satisfied. While these qualifications tend to be very complex in real life application, they can be broadly described as a set of general principles. These principles operate to allow U.S. tax deferral if, and to the extent, each is satisfied:

1. The foreign earnings must be from the active conduct of business.
2. The foreign earnings must be reinvested in foreign operations, and
3. The foreign earnings must either be derived from activities conducted in the same country in which the CFC is organized or be subject to foreign income taxes at a tax rate that is comparable to the U.S. corporate income tax rate.

The corollary to qualifications is that the foreign earnings will be currently taxed in the U.S. if and to the extent that:

1. Earnings are not from business operations (e.g. interest, dividends and other investment “portfolio” type income).
2. Earnings are repatriated to the U.S. as dividends.
3. Earnings are otherwise invested in U.S. property.
4. Earnings are derived outside of the CFC base country and are subject to low income tax rates in that base country.

Familiarity with the basics of U.S. taxation on foreign operations is becoming an increasingly important matter for many mid-sized and sometimes small companies

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In our ensuing issues we will examine some of the finer details of U.S. taxation of foreign operations. **Next up:** Understanding the CFC Branch Rule

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